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Adequacy of Benefits

Background

This report examines the adequacy of retirement benefits by analyzing specific retiree profiles and calculating how the resulting pension benefits perform over time. The report also compares and contrasts Plan 1 and Plan 2 retirees under various scenarios. A comparison with retirement benefits in nine other retirement systems is provided for context. In addition, this report considers the larger social and demographic trends that create risk in terms of maintaining an adequate benefit throughout retirement.

Committee Activity

Presentation:

June 15, 2004 - Full Committee

Recommendation to Legislature

None.

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Select Committee on Pension Policy

Adequacy of Retirement Benefit

(June 8, 2004)

Issue

How do Washington pension benefits maintain their value over time? How does retirement timing affect the benefit over the period of retirement? How do Washington's retirement benefits compare with those of other states? What are some of the demographic and economic trends that place the adequacy of retirement benefits at risk?

This report examines the adequacy of retirement benefits by analyzing specific retiree profiles and calculating how the resulting pension benefits perform over time. The report also compares and contrasts Plan 1 and Plan 2 retirees under various scenarios. A comparison with retirement benefits in nine other retirement systems is provided for context. In addition, this report considers the larger social and demographic trends that create risk in terms of maintaining an adequate benefit throughout retirement.

Many proposals and topics have been submitted to the Select Committee on Pension Policy (SCPP) for study during the 2004 interim. They include the topic "recovery of lost purchasing power," proposed changes to the provisions for adjusting retiree income, and gain-sharing proposals. The Executive Committee of the SCPP has requested that these requests be explored in a larger context that examines the adequacy of Washington's retirement benefits.

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Members Impacted

The purpose of this initial report is to provide a methodology and analytical approach for evaluating the adequacy of a retirement benefit. We have not evaluated every Washington plan; rather, we have examined the Plans 1 and 2 of the largest Washington state pension system, the Public Employees' Retirement System (PERS).

The Teachers' Retirement System (TRS) Plans 1 and 2 have near-identical provisions to PERS Plans 1 and 2. Also, the School Employees' Retirement System (SERS) Plan 2 has essentially the same plan design as PERS 2. The experience within these plans differ primarily in average final compensation (TRS being higher, and SERS being lower than PERS) and service (TRS being longer.) While this results in higher average benefits in TRS and lower average benefits in SERS, the patterns of salary replacement among these systems and plans are essentially the same, with PERS occupying the middle ground. The Plans 3 were not included, since they are hybrid plans with a significant defined contribution component that is highly dependent upon personal savings rates. The report also excludes the Law Enforcement and Firefighters' plans, the Washington State Patrol plan, and the Higher Education plans.

According to the most recent actuarial valuation (based on 2002 data), PERS 1 had 21,737 active and 54,006 retired members, and PERS 2 had 116,939 active and 9,741 retired members.

Current Situation

The following is a summary of the key retirement provisions in PERS.

A. *Service Retirement Allowance*

Eligible PERS 1 retirees receive 2% of average final compensation (AFC) for each year of service credit to a maximum of 60%, with the exception of certain elected officials, who receive 3% of AFC for each year of elective service. For service prior to April 25, 1973, members of the Plans 1 receive the greater of:

1. the sum of a 1% pension, \$100, and an annuity funded by member contributions; or
2. 2% of AFC for each year of service credit to a maximum of 60%.

Service earned by members of PERS 1 prior to October 1, 1947, is factored by 1.42857% of AFC.

Retirees in the PERS Plan 2 receive 2% of AFC for each year of service credit without limit.

B. *Eligibility for Normal Retirement*

PERS 1 members are eligible for normal retirement upon fulfillment of one of the following:

1. five years of service and attainment of age 60;
2. 25 years of service and attainment of age 55; or
3. 30 years of service.

PERS 2 members are eligible for normal retirement upon five years of service and attainment of age 65.

C. *Eligibility for Early Retirement*

There are no provisions for early retirement of PERS 1 members.

PERS 2 members are eligible for early retirement according to the following terms:

1. 20 years of service and attainment of age 55 with the benefit actuarially reduced from age 65; or
2. 30 years of service credit and attainment of age 55 with a 3% per year reduction from age 65.

D. ***Cost of Living Adjustments (COLAs)***

Eligible PERS 1 retirees currently receive the *Uniform COLA*, an annual increase of a fixed dollar amount per month per year of service. This amount increases by 3% annually, and is payable to retirees who are 66 or older and retired at least one year. The increase on July 1, 2004 will be \$1.21 per month per year of service. An eligible retiree with 30 years of service will receive a monthly increase of \$36.30.

Members of PERS Plan 2 who have been retired at least one year receive an annual adjustment based on the CPI-Seattle to a maximum of 3%.

E. ***Minimum Benefits***

As of July 1 of this year, eligible retirees from the PERS Plan 1 will receive a minimum benefit of \$32.97 per month per year of service (before reduction for benefit payment options). Recipients of the minimum benefit automatically receive increases through the Uniform COLA.

Effective July 1, 2004 members of Plan 1 with at least 25 years of service who have been retired at least 20 years will receive a \$1,000 minimum benefit (before reduction for benefit payment options). The benefit is not subject to the Uniform COLA, and will sunset when the existing minimum benefit provisions “catch-up” in about 2010.

There are no minimum benefit provisions applicable to members of PERS Plan 2.

F. ***Gain-Sharing***

Members of PERS 1 may receive periodic permanent increases in their Uniform COLA through gain-sharing, which was introduced in 1998. Gain-sharing is based on “extraordinary” investment returns. When

average returns for the previous four years exceed 10%, one half of the amount in excess of 10% is distributed to Plan 1 members through the Uniform COLA.

There is no gain-sharing provision for members of the PERS Plan 2 because of the cost-sharing provisions that impact member and employer contribution rates.

History

There has been significant legislative activity in both PERS 1 and TRS 1. Minimum benefit and Uniform COLA provisions for these plans were instituted in 1995. The \$1,000 minimum benefit was established during the 2004 legislative session.

Numerous bills have been introduced to address PERS and TRS 1 COLAs. The most recent was SB 6248/HB 2539, which would have changed the age requirement for receiving the initial Uniform increase. The bill would have allowed members who had been retired one year and who turned age 66 in the calendar year in which the increase is given (as opposed to those who turned age 66 by July 1) to begin receipt of the Uniform COLA. This bill was not forwarded from either fiscal committee.

Other legislation has attempted to increase PERS and TRS 1 COLAs through gain-sharing. SB 5516/HB 1426 were introduced in 2003 to increase the frequency of gain-sharing distributions, which currently occurs in even-numbered years. The legislation would have distributed odd-year amounts based on a formula allocating one point for each year of service and two points for each year of retirement. Neither bill received a hearing.

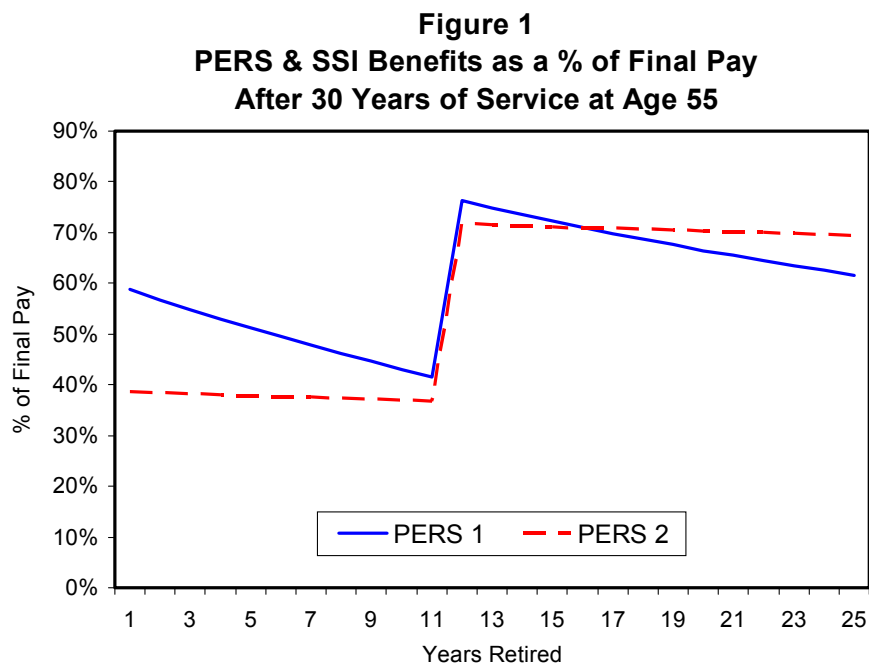
Examples - Pre-retirement Income Replacement

Pension benefits are commonly evaluated on the percent of pre-retirement income they replace. That percentage can range from 60% to 90% depending on individual needs. Examples used in this section will be based on percent of final pay, and how the benefit maintains that percent through a retiree's 80th year.

The examples in this analysis will be based on the following assumptions:

- PERS 1 and PERS 2 plan provisions
- Final annual salary of \$45,000
- Salary increases of 4.5% per year prior to retirement (average final compensation factors of .978 in PERS 1 and .918 in PERS 2.)
- 25 and 30 years of service
- Retirement ages of 55, 60, and 65
- Inflation at 3.5% annual rate (actuarial assumption)
- Social Security (SSI) beginning at age 66 when members would receive an unreduced benefit.

The examples are adjusted for inflation so that the real value of the benefit may be illustrated.

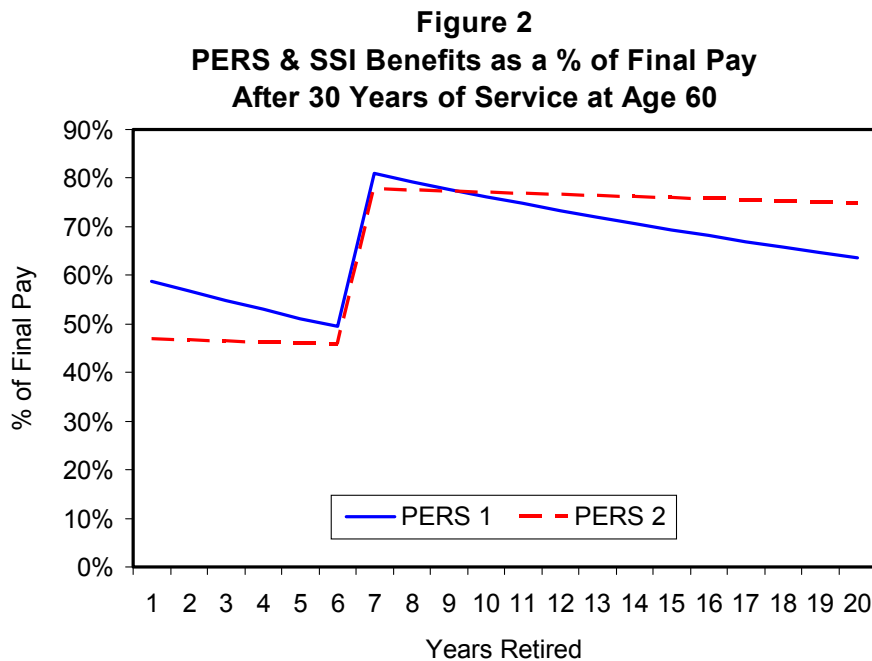


In Figure 1, the member retires at age 55 with 30 years of service resulting in a full benefit in PERS 1 and a reduced benefit (3% per year from age 65) in PERS 2.

The PERS 1 benefit initially replaces nearly 60% of final pay, but quickly loses value because of inflation. After receiving Social Security and Uniform Increases beginning in the 12th year, the combined benefits continue to lose value. While Social Security is fully indexed, its small share of the combined benefits can't offset the diminished value of the PERS 1 benefit.

The PERS 2 benefit, in comparison, begins under 40% of final pay, and retains much of that value as a result of the 3% COLA members begin receiving 1 year after retirement. When the member begins receiving Social Security, the combined benefits equal 72% of final pay and by the 25th year still equal 69% of final pay.

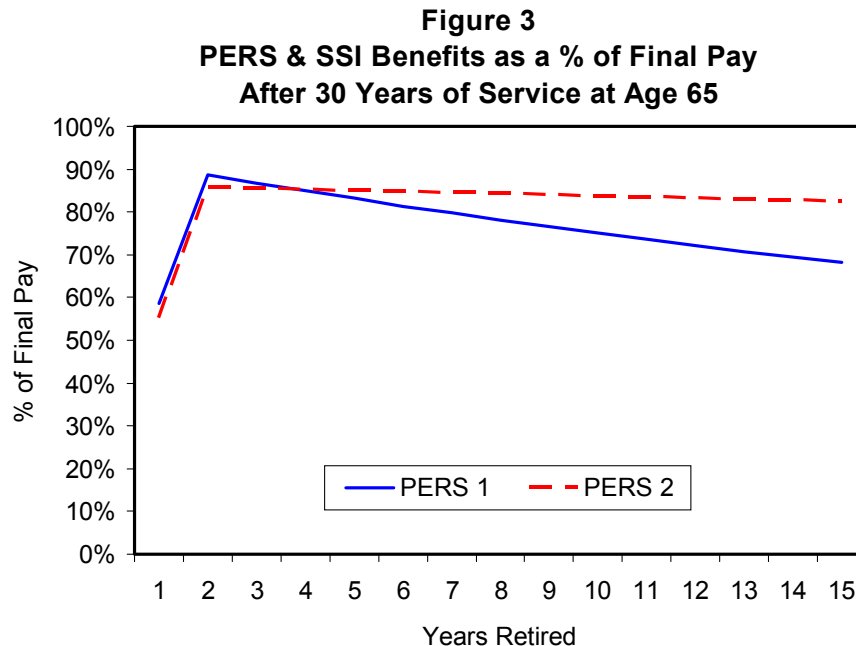
The cross-over point, where PERS 1 and PERS 2 benefits are equal, is the 16th year. While PERS 2 benefits then exceed PERS 1, the accumulated benefits in PERS 1 surpass PERS 2 even after 25 years.



In Figure 2, the member retires at age 60 with 30 years of service. Again, the PERS 1 benefit begins at almost 59% of final salary. As in the first example, the benefit declines because of inflation; in this example, to about 50% of final pay. Upon receiving Social Security and the Uniform Increase in the 7th year, the PERS 1 member's benefit reaches 81% of final pay. Despite the fully indexed Social Security benefit, and the Uniform Increases, the PERS 1 benefit continues to diminish in value to about 64% of final pay by the time the member reaches 80 years of age.

The PERS 2 benefit, on the other hand, begins at 47% of final pay, and retains that value as a result of the plan's COLA provision. Upon receiving Social Security, the combined benefits increase to 78% of final pay and, by the time the member reaches 80 years of age, are still 75% of final pay.

The cross-over point, where PERS 1 and PERS 2 benefits are equal, is at 9 years of retirement. The point at which accumulated benefits in PERS 1 and PERS 2 are equal is at 18½ years.

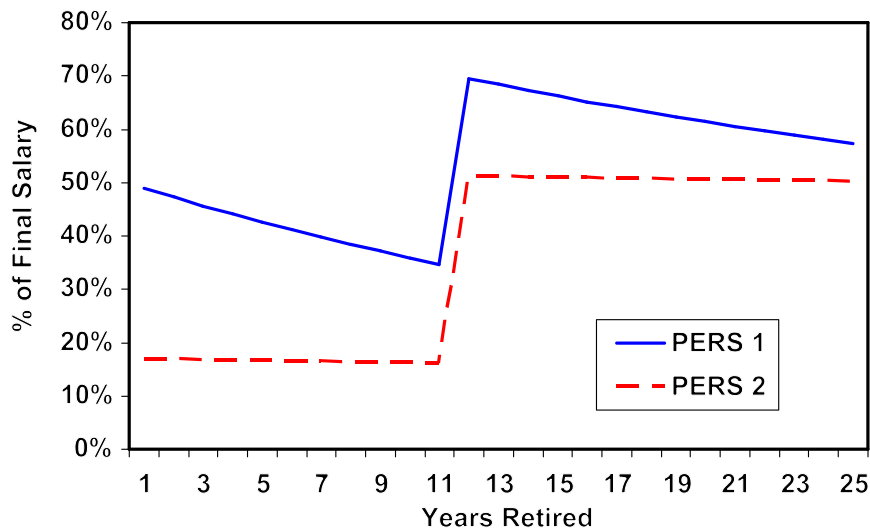


In Figure 3, the member retires at age 65 with 30 years of service. The PERS 1 member begins receiving Social Security and the Uniform Increases in the 2nd year of retirement, and the combined PERS and Social Security benefits equal 89% of final pay. As in the previous examples, the combined benefits decline in value to about 68% of final pay by the time the member reaches 80 years of age, this despite Social Security indexing and the Uniform COLA.

The PERS 2 benefit begins at 55% of final pay, several percentage points below the PERS 1 benefit. Upon receiving Social Security in the 2nd year of retirement, the combined benefits increase to 86% of final pay and, by the time the member reaches 80 years of age, are still over 83% of final pay.

The cross-over point, where PERS 1 and PERS 2 benefits are equal, is at 3½ years. The point at which accumulated benefits in PERS 1 and PERS 2 are equal is at 6½ years. Thereafter, PERS 2 benefits surpass PERS 1 benefits in all measures.

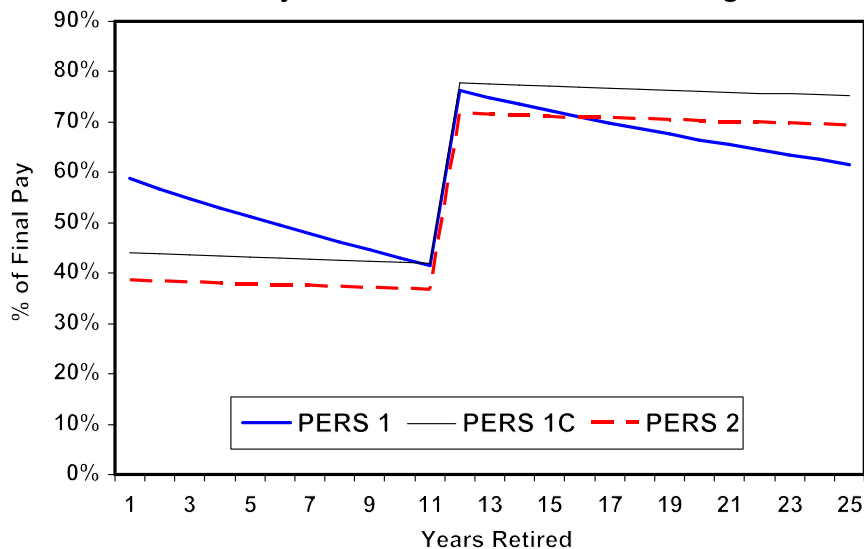
Figure 4
PERS & SSI Benefits as a % of Final Pay
After 25 Years of Service at Age 55



In Figure 4, the member retires after 25 years of service at age 55. As in all these examples, the PERS 1 member is eligible for an unreduced benefit. At 25 years of service, however, the PERS 2 member's benefit is subject to a full actuarial reduction – about 8% per year from age 65. While the PERS 1 benefit begins at 49% of final pay, the PERS 2 benefit begins at 17%. After 10 years of receiving benefits, the plan 1 member still receives almost double the plan 2 amount. Upon receipt of Social Security benefits, the plan 1 member's benefits reach 69% of final pay, while the plan 2 member's benefits increase to 51% of final pay.

Still quite evident in this analysis is the inflation impact on the PERS 1 benefits, even after inclusion of Social Security and the Uniform Increases. Because of the severity of the actuarial reduction, there is no cross-over point on this illustration where the PERS 2 benefit surpasses PERS 1, even after accounting for the effects of long-term inflation. This, more than any other example, illustrates the greater value of the PERS 1 benefit at earlier ages.

Figure 5
PERS Optional COLA & SSI Benefits as a % of
Final Pay After 30 Years of Service at Age 55



As a final example, Figure 5 illustrates the share of final pay a plan 1 member would receive were they to choose the optional COLA payment upon retirement. The optional COLA payment allows a plan 1 member to receive an actuarially adjusted benefit that will increase with inflation, to a maximum of 3% per year, beginning one year after retirement – the same as the plan 2 COLA. The actuarial reduction for a member at age 55 is a factor of .751 meaning the adjusted initial benefit is about three-fourths of the original benefit.

The initial replacement rate declines from 59% to an adjusted 44%. Most obvious in this example is the stability of the adjusted benefit stream, essentially paralleling the plan 2 pattern. By accepting a reduced benefit in the beginning, the member is assured of receiving a more stable benefit over their retirement.

When the member becomes eligible for an unreduced Social Security benefit, the combined replacement rate reaches 78%, higher than the unadjusted rate. Because this is an actuarial adjustment, the accumulated benefit should be the same under either benefit at the end of the member's life.

In each of the previous five examples, the plans provide a benefit that replaces a significant share of final pay, particularly when the member retires at a later age. In concert with Social Security, the benefits can replace close to 90% of

final pay when members retire at age 65. While PERS 2 can't replace as great a share of salary as PERS 1 at early retirement ages, it can at later ages, and at all ages it maintains a more constant benefit.

Examples - Retention of Original Purchasing Power

Another method to illustrate the adequacy of benefits is to analyze how well they retain their original purchasing power, i.e. how well they protect retirees from inflation. The following examples will examine actual retiree benefits against actual inflation history for PERS 1 and PERS 2 members who retired at 55, 60, and 65 years of age. This is a necessary complement to the previous examples with an assumed rate of inflation because inflation is not necessarily a constant; it is higher in some years and lower in others. As a result, the timing of retirement has a direct bearing on how well the value of the benefit is maintained.

For instance, a member retiring in 1979 would have been subject to over 16% inflation in 1980, 10.8% inflation in 1981, and 6.5% inflation in 1982 (see Figure 6), which would have caused a 27% loss of purchasing power over a very short period of time. A member retiring more recently, however, would have been spared such immediate diminishment of their benefit's value as consumer prices in the Puget Sound region rose 1.8% in 2002, and 1.4% in 2003.

Figure 6
Annual Percent Changes Seattle CPI-W
1979 - 2003

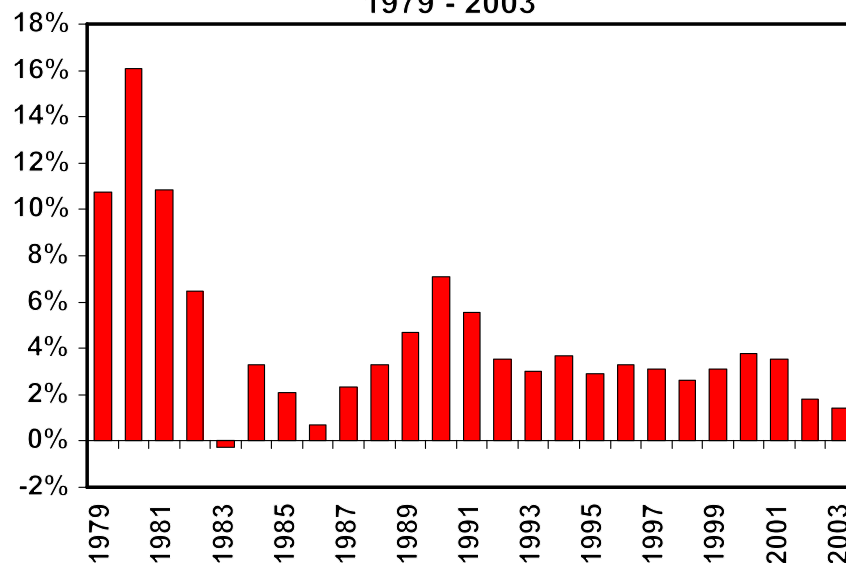


Figure 7 shows the current purchasing power of PERS 1 members who retired at age 55, 60, and 65 by year of retirement. The loss of purchasing power for those retiring at age 55 is persistent, even after they become eligible for the Uniform Increases. Those who retired at age 60 experienced a loss of purchasing power for the first 6 years of retirement, similar to those who retired at 55. As the Uniform Increase becomes available, the purchasing power of these benefits tends to even out. The benefits of those retiring more recently at age 65 have retained a significantly greater portion of their purchasing power than the benefits of those retiring at younger ages. Also evident is the loss of purchasing power, regardless of age at retirement, among those who have been retired the longest.

Among these groups, those who retired most recently at older ages were more able to benefit from the Uniform COLA. The benefit of those who retired at age 65 in 1989 has retained over 78% of its original purchasing power. The benefit of those retiring at age 60 in 1984 has retained 77% of its original purchasing power. Those who retired at age 55 in 1979 have experienced the loss of over 50% of their original benefit's purchasing power.

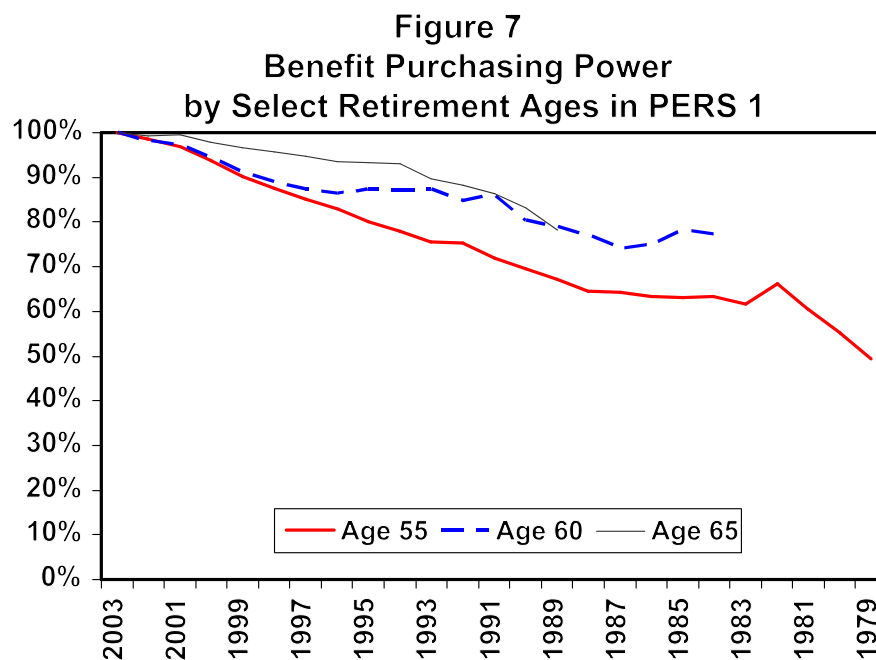
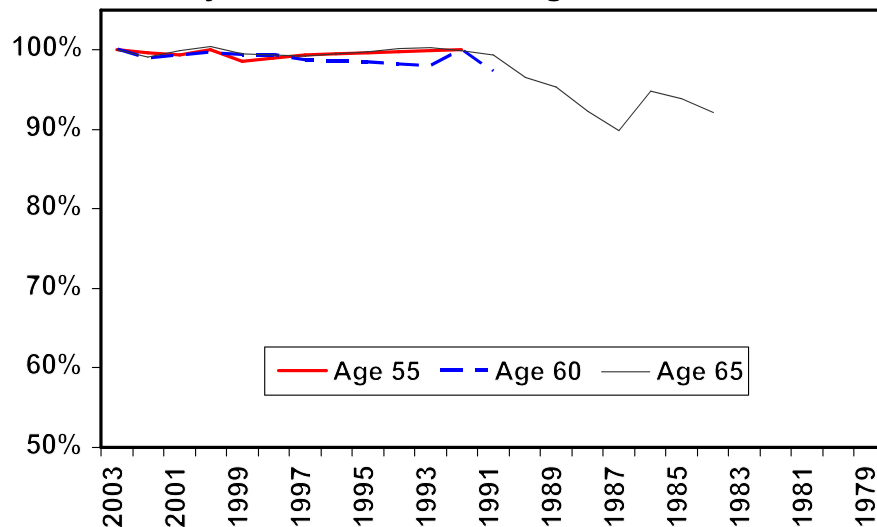


Figure 8 provides a distinct contrast between plan 1 and plan 2. The ability of a PERS 2 benefit to retain its purchasing power is evident. The benefit of those who retired at age 65 in 1984 has still retained over 92% of its original

purchasing power. More evident here is the ability of a PERS 2 benefit to retain its purchasing power among those retiring at age 55 and 60, groups whose benefits become significantly diminished over time in PERS 1.

Figure 8
Benefit Purchasing Power
by Select Retirement Ages in PERS 2



Policy Analysis

Retirement benefit adequacy covers a wide range of discussions. The following analysis will touch on current plan 2 policies that were established to address some of the design shortcomings of plan 1. Comparisons of plan designs will be made between select Washington plans and among several state and city peers. A discussion of income replacement is also included as it forms the basis for the examples leading this analysis. Following that will be a discussion on the “Three-Legged Stool” model of retirement income, as adequacy cannot be determined by just one component of a retirement plan but by all – employer pensions, Social Security, and personal savings. Personal savings, savings rates, and how members of the baby boom population are preparing for retirement will then be discussed because personal savings is a much ignored leg of the stool. An analysis of our aging population will show how longevity has had a significant impact on retirement plan costs and plan design. Among the costs borne by retirees as they live even longer is health care. This final discussion will touch on health care as both an employment benefit and as a growing part of retirees’ expenses, and will compare what other retirement plans offer.

A. ***Plan 1 and Plan 2 Policies***

This analysis is primarily a comparison of the plan 1 and plan 2 retirement policies. As such, current implicit retirement policies, which have driven the design of the plans 2/3, tend to illustrate some of the conflicting elements of the plan 1 design that the legislature wanted to address in the plan 2s. Foremost of these policies are:

- retiree benefits should have some form and degree of protection from inflation; and
- plan design should be as neutral as possible in its effect on employees, and should not encourage early retirement.

In terms of inflation protection, the plan 2 design includes a cost of living adjustment beginning one year after retirement, including for those retiring early. So even though there is a penalty for retiring early in plan 2 in the form of actuarial or 3% per year benefit reductions, which would discourage early retirement, the early retirement benefit is still protected from rising consumer prices. As a result, plan 2s adhere to the policies outlined above.

Inflation protection in plan 1, which is based on service rather than salary, begins at age 66 regardless of the age at which a member retired. As the plan design maximizes a member's benefit at 30 years of service, and has generous post-retirement employment benefit improvements, there is an incentive to retire after 30 years, even for members in their early to mid-50s. As a result, the plan 1s earlier retirement and no COLA for earlier retirees partially comply with current policy on inflation protection, though not from the date of retirement, and, for early hires, are in conflict with current policy discouraging early retirement.

B. ***Comparisons with Other Washington Systems/Plans***

LEOFF 1: The invariable comparison in the Washington systems is with the Law Enforcement Officer's and Fire Fighter's retirement plan 1 (LEOFF 1). Provisions in LEOFF 1 allow a member to retire with an unreduced, fully indexed benefit after five years of service at age 50. While this is contrary to the policy against encouraging early retirement, deference has been given to the dangerous nature of jobs covered by this plan. Those who retire because of a duty-related disabling injury receive a tax-free benefit which increases its value beyond the dollars it

represents. With a fully indexed benefit, LEOFF 1 members are protected against all levels of inflation, unlike the Uniform Increase provisions in the other plan 1s, and the 3% capped COLA in the plan 2s and 3s. LEOFF 1 retirees are also provided full medical coverage in retirement by their former employer. This coverage insulates them from the high levels of healthcare inflation that capture an ever-increasing share of other retirees' benefits. If reasonable salary replacement, protection against high levels of inflation and healthcare costs are the measure of adequacy, then the LEOFF 1 plan would be the benchmark for all comparisons. In light of the level of benefits, the contribution rates for LEOFF 1 have been much greater than any other public plan in Washington State, and those contributions do not account for the medical benefits retiree's former employers are obligated to pay. When retirement contributions were being made in LEOFF 1, employers and employees each paid 6% of pay while the state was obligated to pay double or triple that amount.

Plan 3s: Other Washington retirement plans to compare with the plan 1s and plan 2s are the plan 3s. These plans are hybrid plans that have both a defined benefit and a defined contribution component. Unlike the shared cost nature of the plan 2s, the plan 3s seek to share the risk of the retirement plan as well. Members choose the share of salary they contribute to their defined contribution accounts and also choose the investment portfolio. The employer makes retirement contributions for the defined benefit which will provide members with 1% of their average final compensation for each year of service. The defined benefit is protected by a CPI-based COLA with a maximum 3% adjustment per year. As a result, the member assumes not only the risk of the investment returns on their defined contribution account, but also whether those returns will be substantial enough to protect that portion of their retirement benefit from inflation.

Higher Education Plans: Higher Education retirement plans in Washington are primarily defined contribution plans. Members and their employers each contribute either 5%, 7.5%, or 10% of the members' salary to the members' accounts depending on the members' ages. The member is then responsible for the investment portfolio i.e. where the account monies are invested. In this system, the member assumes the majority of the risk of the plan, unlike the plan 1s and 2s where the

employer is the guarantor of the value of the retirement benefit and assumes the risk. At the end of their careers, higher education plan members are responsible for establishing a distribution method that will provide them with an income stream for the remainder of their lives.

Higher education members do not assume all the risk in their plan. Upon meeting specific service requirements, members are eligible for a supplemental retirement benefit that guarantees them a minimum of 50% of the average of their highest two consecutive years salary.

Risk Sharing: The contrast between Washington's retirement plans is primarily in who assumes the risk. In the PERS and TRS plan 1s, the employers assume the risk of the basic benefit, but members assume all the risk of inflation if they retire before age 65 and some inflation risk afterwards. LEOFF 1 employers assume all the risk of the benefit and inflation, including health care inflation, as the members' benefits have a fully indexed COLA. Plan 2 members share the costs of the plans, but the plan design guarantees the benefit and protects that benefit from moderate inflation. Plan 3 members assume at least half the risk in their retirement benefits, and higher education members would assume all in absence of the supplemental benefit.

C. **Plan Design Comparisons With Peer Systems**

Retirement plan design changed significantly between PERS 1 and PERS 2 to accommodate the changes in policy. The shift from a service-based to an age-based plan, and the availability of an automatic post-retirement COLA are the major distinctions between the two designs. How do other systems compare with these basic elements? Figure 9 illustrates these elements among some peer systems.

Figure 9
Benefit Formulas, Limits, and Retirement COLAs by Select Plans

System	FAS Period	Formula Multiplier	Limit	COLA
Cal PERS	1 YH	2.0% at 60, 2.418% at 63	None	2%
Cal STRS	3 YHC	2.0% at 60, 2.4% at 63	100%	2%
Colorado PERA*	3 YH	2.5%	100%	3.5%
Florida (FRS)	5 YH	2.0%	100%	3%

System	FAS Period	Formula Multiplier	Limit	COLA
Idaho (PERSI)	42 MC	2.0%	100%	1% min, 6% max, CPI base
Iowa (IPERS)	3 YH	2.0 % in 1 st 30 yrs., 1% next 5 yrs.	65%	CPI - 3% max
Minnesota (MSRS)	5 YHC	1.7%	100%	CPI - 2.5% max invest. surplus
Missouri (MOSERS)*	3 YHC	2.5%, 2.55% with 31 or more yrs. of service	None	CPI - 5% max
Ohio (OPERS)*	3 YH	2.2% 1 st 30 YRS, 2.5% YRS > 30	100%	CPI - 3% max
Oregon PERS*	3 YH	2.2% 1 st 30 yrs. 2.5% yrs > 30.	None	CPI - 2% max
Seattle (SCERS)	2 YHC	2.0%	60%	1.5%

* No Social Security

Y = Year; H = High; C = Consecutive; M = Monthly

In the above cross section of public retirement plans (Figure 9), there are numerous similarities:

- Most have at least a 2% formula, meaning that a member with 30 years of service will receive 60% of average salary upon retirement. These plans implicitly acknowledge the 60-90% salary replacement standard.
- Those with a formula greater than 2% tend not to have Social Security benefits, the higher formula recognizing that when Social Security is missing, the employer provided benefit must be more substantial.
- All but one have a multi-year averaging of final salary -- the most common being a 3-year average -- acknowledging that late career promotions do have retirement benefit consequences.
- Two have effective limitations on the size of the benefit a member may earn. Others allow up to 100% salary replacement or greater, thus encouraging longer service.
- All of the plans have Cost of Living Adjustments. Four of the plans use CPI-linked COLAs, the others use a straight percentage adjustment per year.

These plan design characteristics indicate that the standard 60% salary replacement is considered a minimum for an employee with 30 years of service. They also indicate that more service will generate a larger

benefit, an incentive to work longer. The COLA provisions offer the member reasonable protection from inflation and those plans in which the employees did not make Social Security contributions offered the highest initial replacement rate and inflation protection.

D. ***Income Replacement Ratio***

Because retirement preparations are largely a matter of personal choice, there is no widely accepted national standard for what constitutes an adequate or appropriate level of income replacement.

Investorwords.com, which claims to be the biggest and best investing glossary on the worldwide web, defines “income replacement ratio” as “the percentage of working income that an individual needs to maintain the same standard of living in retirement, usually 60-90%.” As reflected in this definition, there is an absence of a single standard. Researchers have used a number of different measures to assess the adequacy of retirement preparations, and have come to a variety of conclusions.

Moreover, many financial experts are reluctant to recommend a particular income replacement ratio, as needs for individuals will vary according to many factors. Those factors include age of retirement, location of retirement, cost of living, value of personal assets, lifestyle, health factors, availability of medical insurance, expenses related to long-term care, and many others. Thus, individuals are usually encouraged to calculate their own retirement needs according to their expected plans.

E. ***The “Three-Legged Stool”***

Acknowledging that retiree income from pensions may be inadequate, the United States has traditionally depended on what is often referred to as the “three-legged stool” -- Social Security, employer pensions, and personal savings – to finance retirement. However information on actual income sources for persons over age 65 reveal a disconnect between the model and actual behavior. In addition, recent trends appear to be weakening each “leg” of this traditional model.

While Social Security and Medicare have long been the most stable leg of the stool, both are facing projected long-term shortfalls due to a combination of the imminent retirement of the baby boom generation, lengthening life spans, and rising per-capita health care expenditures. For the average earner who retires at 65, Social Security currently

provides benefits equal to 41.3% of pre-retirement earnings, or 38.5% of earnings after deducting Medicare Part B premiums. But for someone retiring in 2030, Social Security benefits are projected to replace 29.9% of pre-retirement wages. The reasons for the decline include the slated increase in the normal retirement age to 67, the rising cost of Medicare Part B premiums, which are automatically deducted from Social Security benefits, and the expanding taxation of Social Security benefits under the personal income tax.¹

With respect to public and private pension plans, funding has diminished in recent years. In the public sector, state and local retirement plans are facing daunting future contribution requirements after many plans improved benefits and took funding holidays in response to the gains of the late 1990's, and then faced poor stock market performance during the period from 1999 to 2002. Similarly, in the private sector, 58% of private pension plan sponsors surveyed by Deloitte Consulting in early 2004 listed the following two primary concerns about their pension plans: the amount of the future cash contribution and the effect of the plan's expense on financial statements. These sponsors identified reducing cost as the single largest expected outcome from a new retirement plan design.

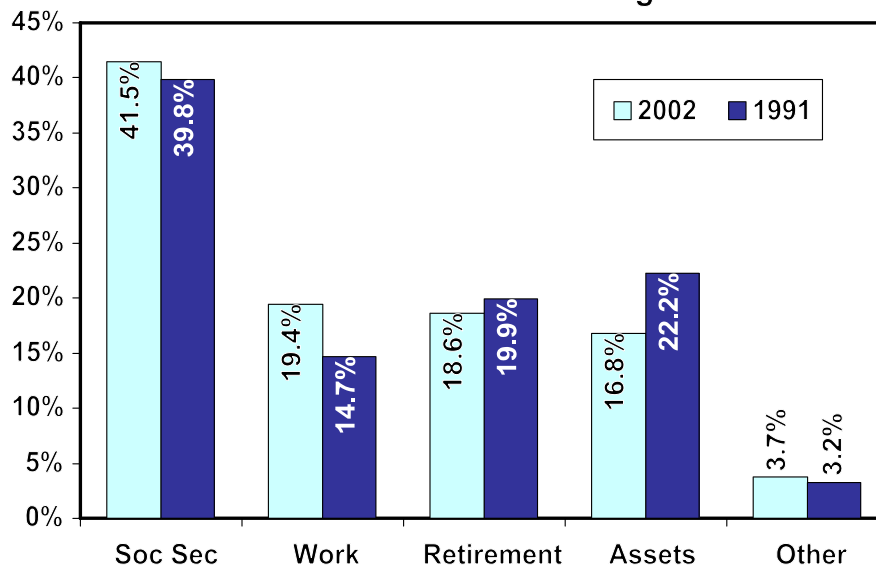
Finally, personal savings rates for a majority of households have been extremely low in recent years, and some households save very little and have few financial assets. The Federal Reserve's 2001 Survey of Consumer Finances reported that the typical household approaching retirement has only \$55,000 in its supplemental retirement account, an amount which is needed to support two decades in retirement.²

F. *Post-Retirement Income Sources*

What are the actual sources of income for those over age 65? The answer to that question gives an indication of the current adherence to the three-legged stool model. The Employee Benefit Research Institute recently published income statistics from the most recent Current Population Survey showing the 2002 percentage distribution of average income by source for the population age 65 and over (see Figure 10). This report showed that 19.4% of the income for this group was from earnings from work, 41.5% of income was from Social Security, 18.6% was from retirement plans of various types, 16.8% was income from

assets, and 3.7% was income from all other sources, including financial assistance, non-pension survivor benefits, disability, unemployment compensation, workers' compensation, veterans' benefits, and public assistance.

Figure 10
Sources of Income After Age 65



These figures were slightly different in 1991, when there was a higher percentage of income from assets (22.4%) and less reliance on income from work (14.7%). Social Security represented 39.8% of income in 1991, 19.9% of income was from retirement plans of various types, and 3.2% of income was from all other sources.

Considering the above figures, the three legged stool has some legs that are shorter than others. Also, there are components of actual retirement income that are not reflected in this model, the most significant of which is income from continuing to work after retiring from a primary job. According to Merrill Lynch's 2004 Retirement Preparedness Survey, 54% of Americans intend to work full or part-time after age 65, citing financial reasons. The desire and need for a phased retirement has been growing. While not a part of any formal plan design, the income sources in figure 10 show that retirees have instituted their own form of phased retirement.

G. **Personal Savings**

As personal savings are an important leg of the three-legged-stool model, it is necessary to examine peoples current saving behavior. That behavior is largely influenced by their expectations about the future. The Employee Benefits Research Institute recently published its 14th annual Retirement Confidence Survey, a study of the attitudes and behaviors of American workers and retirees toward saving, retirement planning and long-term financial security. The following are some of the survey's findings.

Four in ten workers say they are not currently saving for retirement. Many of those with savings cite low levels of savings.

Few workers appear to have an idea of how much it takes to live comfortably in retirement. Only about 4 in 10 have taken steps to calculate how much they need to save in order to live comfortably in retirement, and one-third of those say they don't know or can't remember the result of the calculation.

Almost half of workers who have not saved for retirement feel at least some confidence about their ability to have a comfortable retirement. Some of these workers expect an employer to fund their retirement. Others are planning to save later, rely on Social Security, obtain support from family or friends, work in retirement, or manage through some other arrangement.

A majority of Americans report that they have saved some money for retirement, but many have saved only a small amount, and savings rates have not increased in recent years.

Some workers have expectations about their retirement that cannot be achieved. Workers tend to expect their living standard to be at least as good as before retirement and to remain so throughout their retirement. For some, this is unlikely due to increasing medical costs, declining savings and inflation. Unrealistic expectations have likely led to the low savings rates as illustrated in Figure 11.

Figure 11
Total Savings and Investments, by Age

	All	25-34	35-44	45-54	55+
Less than \$25,000	45%	64%	48%	30%	29%
\$25,000 - \$49,000	11%	17%	11%	9%	5%
\$50,000 - \$99,000	9%	7%	10%	9%	10%
\$100,000 - \$249,000	10%	2%	9%	19%	13%
\$250,000 or more	8%	3%	7%	10%	13%
Don't Know / refused	18%	8%	15%	24%	30%

Source: Employee Benefits Research Institute, American Savings Education Council, and Matthew Greenwald & Associates, Inc. 2004 Retirement Confidence Survey

Note: This survey excluded the value of the respondents' residence. Many home-owners do consider their homes savings instruments. While demographic patterns may result in diminished home values in the future, care should be given when drawing conclusions on results that exclude such a significant personal asset.

Finally, the survey showed that *retirement education can lead to changes in savings behavior of a significant proportion of workers*. More than 4 in 10 workers who tried to do a savings need calculation reported changing their retirement planning as a result. Similarly, almost 3 in 10 of those who received retirement education through the workplace changed their retirement planning.

H. ***Are Boomers Ready?***

More specific information on retirement preparedness is available for the Baby-Boom generation (people born between 1946 and 1964). Their approaching retirement has become a public concern - partly because of the budgetary pressures that will develop when baby boomers collect Social Security and federal medical benefits, but also because of claims that boomers are not accumulating enough private savings to finance their retirement.

According to the Congressional Budget Office (CBO) baby boomers make up one of the largest and most prosperous generations in U.S. history. The CBO recently reviewed the research that has been conducted over the past decade on the retirement prospects of aging Americans in a report entitled "Baby Boomers' Retirement Prospects: An Overview" published in November, 2003.

The CBO found that most studies of retirement preparation use a standard derived from economic theory suggesting that people will try to maintain the same level of well-being throughout their lifetime. The studies that apply such a standard suggest that about half of boomer households are on track to accumulate enough wealth to maintain their current standard of living if the heads of households retire as scheduled.

At the other end of the spectrum, roughly a quarter of the households - many of them low-income households with low-skilled workers - have accumulated few assets thus far and are likely to find themselves dependent on government benefits in retirement. For those in low-income households, Social Security benefits may be sufficient to maintain working age consumption because Social Security benefits will replace a larger share of their earnings. Other households in the low-saving group could face a significant decline in their standard of living during retirement.

For the remaining quartile of boomer households, the evidence is more mixed. Studies that use optimistic assumptions conclude that those households are reasonably well-prepared. For instance, if those households earn fairly high returns on their savings, work until they qualify for full Social Security benefits, and draw on their housing equity to finance some of their consumption during retirement, most of them should be able to maintain their current living standard. However, studies that use more pessimistic assumptions conclude that members of those households may face significant shortfalls if they earn relatively low returns on their savings, retire before age 62, and never choose to draw on their housing equity. Housing equity is important as home ownership is viewed by many as a savings instrument. The ability to draw on that equity may be a growing demographic issue as the increasing number of older home-owners may find themselves competing for the smaller ranks of young home-buyers.

For households facing shortfalls, the CBO suggests that relatively small changes in behavior can have surprisingly large effects. For example, on average, for each year that people who have reached age 62 postpone retirement, they reduce their need for retirement savings by about five percent. An extra year of work also increases their Social Security benefits by several percent. Taken together, these effects lessen the total

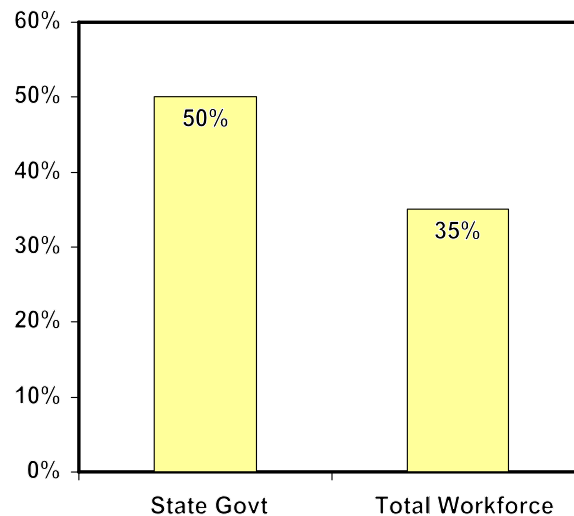
amount that people need to save, and the additional year(s) working give them time to save more and earn returns on the assets they have already accumulated.

Nearly all the studies that the CBO reviewed assumed that Social Security and other government benefits will be paid as prescribed by current law. However, budgetary pressures could result in lower benefit levels for future recipients. Because baby boomers in the lowest income quartile are likely to depend on government benefits for nearly all of their income in retirement, their current prospects depend heavily on the future of Social Security.

I. ***Boomers in State Government***

Baby boomers are a significant part of Washington State's public sector workforce. More than 50% of state employees are 45 or older, and 15% are 55 or over. In the state workforce at large, more than 36% of employees are 45 or older and about 14% are 55 or over (see Figure 12). According to the Department of Personnel (DOP), the state will experience significantly higher turnover in the near future due to increasing retirement rates, with some agencies and job categories impacted to a much greater extent than others.

Figure 12
Share of Workforce Over Age 50



Source: DOP and BLS

With more than 50% of executive level and 30% of mid-level managers eligible to retire by 2005, agencies will be challenged to replace highly skilled and experienced employees, especially in occupations and locations where the labor market is particularly competitive (DOP).

In response to these trends, the following are among the recommendations of the Task Force on the Changing Age Profile of the Washington State Government Workforce published by the Department of Personnel (2000):

- Explore options to help retain experienced workers (such as scheduling flexibility, tele-commuting, assignment or career changes, leave options and downshifting).
- Eliminate barriers to post-retirement employment and/or allow exceptions so that agencies can provide health care coverage as an incentive for retirees to work part-time. To this end, the DOP is currently developing a pool of retirees interested in state positions.

Both national and state trends indicate that there is a need to encourage experienced workers and retirees to stay within the workforce, even if only on a part-time basis. Based on the income statistics summarized above, it appears that many of those over age 65 have inadequate savings and are indeed working.³

J. ***The Aging Population***

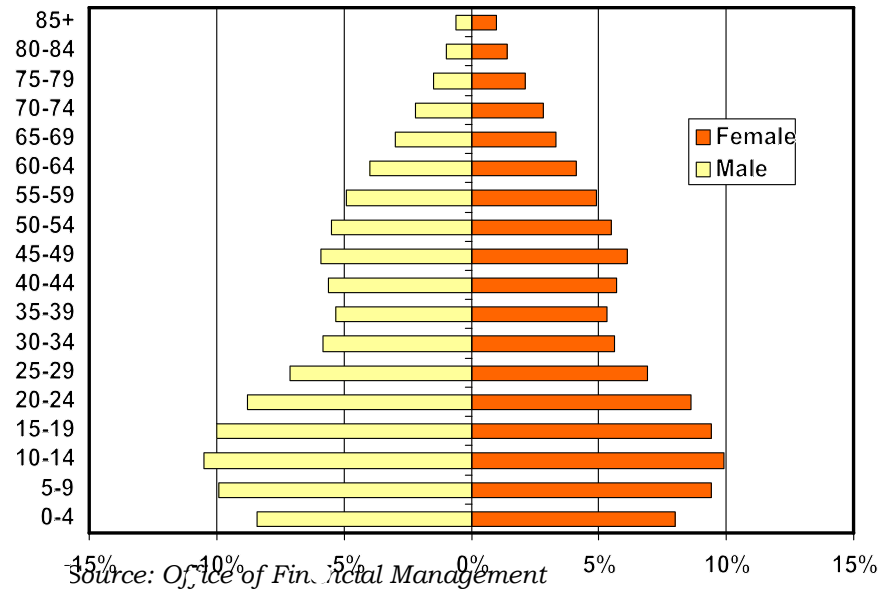
An aging population has distinct needs, and also has distinct impacts on retirement system costs and designs. Living longer is obviously more costly. But living longer will also have a bearing on when workers want to retire.

How has Washington's population aged? An examination of age cohorts from 1970 and the forecasted figures for 2030 provides a dramatic contrast.

In 1970, the distribution of Washington's population was distinctly young. The largest 5-year cohort was the 10-14 age group (see Figure 13); this being the final wave of baby-boomers. There was an obvious

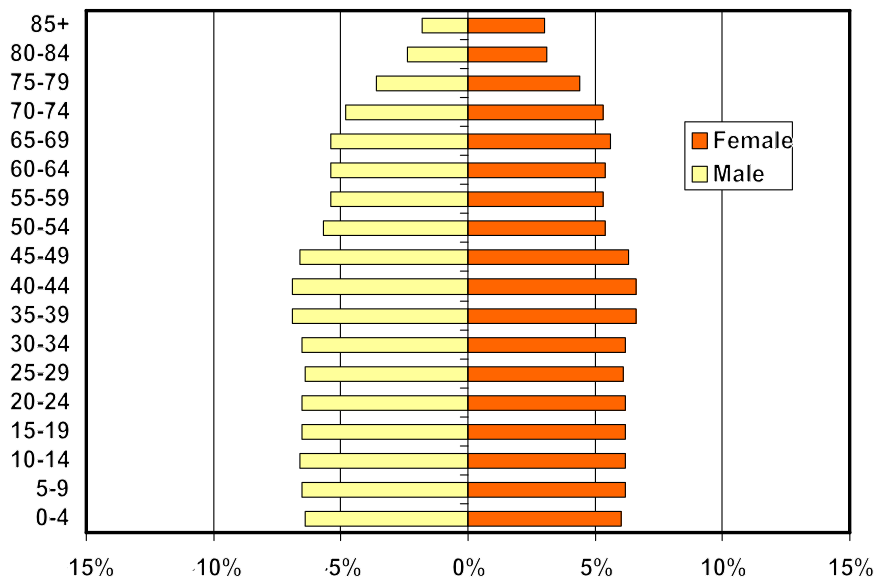
“waist” in the pattern because of the lower birth rates during the “Great Depression”. After age 50, each succeeding older cohort held significantly fewer members.

Figure 13
Washington Population Shares by Age and Sex: 1970



By 2030, the population of Washington will be significantly older. The pattern holds much fewer young people, and in contrast to the 1970 figures, the largest population cohorts will be those in their mid-thirties to mid-forties (see Figure 14). This is the result of the aging of those who were 10-14 years of age in 1970, plus those who came to Washington in the intervening years. There will no longer be the gradual diminished populations beginning at age 50. Only after age 70 will the decreases be most evident.

Figure 14
Washington Population Shares by Age and Sex: 2030



Source: Office of Financial Management

K. **National Population Trends**

The U.S. population has been growing older since the nation was founded. This long-trend is the inevitable result of two factors: (1) women have generally been having fewer children than in previous generations; and (2) individuals have been living longer.

Immigration, the other key factor in U.S. demographics, also plays a role. Immigrants are disproportionately prime-age adults, and tend to have higher fertility rates than native born Americans. Thus, the decline in immigration after the First World War contributed to population aging in the mid-twentieth century. The recent rise in immigration will slow the aging process too, but only if the flow of immigrants is relatively constant.

As the result of a more urbanized population base, a higher likelihood of children surviving to maturity, and increased birth control, fertility rates have declined dramatically from the beginning of the 19th century. In this long-term context, the baby-boom was a demographic deviation that temporarily interrupted the decline in fertility, with the subsequent baby “bust” bringing fertility back to its long-term historic trend.

The other demographic factor driving the aging of the population is increased life expectancy. In 1935 when Social Security was enacted and the retirement age was set at 65, life expectancy at birth was 59.9 years for men and 63.9 years for women. At age 65, men could expect to live another 12 years and women another 13. As of 2001, life expectancy at birth was 74.4 years for men and 79.8 years for women. A man age 65 in 2001 could expect to live another 17 years. A woman age 65 in 2001 could expect to live another 20 years. By 2080, life expectancy at 65 is expected to be 20 more years for men and 23 more years for women. The outlook for 2080 reflects the long-term trends in fertility and life expectancy, and not the so-called baby boom.⁴

As Americans age, pay-as-you-go benefits such as Social Security are jeopardized as there are fewer workers to support each pensioner. The possibility of tax increases, benefit cuts, and ever greater public debt are the unpopular budget choices associated with Social Security reform.

As a result of aging, pre-funded plans like Washington's are becoming more expensive; benefits must be paid over a longer period. For those who depend more on defined contribution plans or hybrid plans, like plan 3s, longer retirement periods mean a greater risk of outliving retirement benefits. And as shown earlier, the longer the retirement period, the greater the risk of higher inflation. Finally, as the population ages, health care costs increase significantly.

L. *Benefits, Compensation and Retirement*

Another factor in determining the adequacy of retirement income is the extent to which it is expected to pay for other non-retirement benefits. Employment benefits have become an increasingly large part of the public employee's compensation package. These benefits include not just retirement plans, but also holiday, vacation, personal, funeral, jury duty, military, family, and sick leave; short-term disability, long-term disability, and life insurance; medical, dental, and vision care; and legally required benefits – unemployment insurance and worker's compensation.

As these benefits command a higher share of the compensation package, particularly the "in lieu of wages" benefits like health care insurance, the difference between what is provided during employment and what is provided during retirement grows. As a result, the real replacement

value of retirement benefits are lessened. According to the Public Employee's Benefits Board an active PERS member with a spouse and child will receive, in 2004, a tax-free health care benefit from their employer worth approximately \$900 per month -- over \$10,000 per year. As a result, the compensation of the average PERS employee is over \$55,000 per year because of the benefits that supplement a \$45,000 salary. For a 30-year employee, the current benefit structure replaces about 60% of salary, but less than 50% of compensation (see Figure 15). Because of the fixed nature of the health care benefits, lower wage members' retirement benefits replace less of their "total" compensation, while for higher wage members the replacement rate is more.

Figure 15
Benefit Analysis: Salary and Health Insurance

	Salary for Retirement	Salary + Pre-retirement Health Insurance
Benefit Base	\$45,000	\$55,000
Retirement Benefit	\$27,000	\$27,000
Replacement Rate	60%	49%

Retirement benefits relative to "total" compensation is an issue because of the growing cost of health care and the differing definitions of retirement compensation in Washington State. The statutory language in the PERS, SERS, and TRS retirement chapters limits compensation to essentially wages and salaries. The statutory language governing workers compensation benefits, which includes disability retirement, uses a definition of compensation that includes, "...wages, medical, dental, and vision benefits; room and board, housing, fuel, bonuses, and tips."

Note: Statutory language in the PERS and TRS plans includes the term "average final compensation" but define compensation so as to exclude all other components of the compensation package save wages and salaries. The LEOFF and State Patrol plans use the statutory term "average final salary."

M. ***Rising Health Care Expenditures***

Of the risk issues facing retirees today, the cost of health care is probably the most important. As health care costs rise beyond normal inflation, they command a greater share of retirees' income, forcing them to scale back on other living expenses and thus diminishing the overall adequacy of their retirement benefit.

For much of the 1990's, health care costs in this country were held in check. With a tight labor market, employer-provided health care was a competitive necessity to attract and retain employees and the ability to control costs made these popular benefits economically feasible for employers to offer.

Recently this trend began to reverse. In 2001, employers experienced an average health care premium increase of 13%.⁵ The National Conference of State Legislatures, citing Deloitte & Touche's September 2003 Employer Survey, reports that the costs of employer-sponsored health care plans rose 14.9% in 2003, from an annual \$5,239 per employee in 2002 to \$6,020 per employee. Survey respondents predicted that their 2004 plan costs would rise again an average of 14.3% to \$6,880 per employee.

Nationally, health care spending is projected to be \$1.7936 trillion, or 15.5% of the total gross domestic product (GDP) in 2004. This will be \$6,167 per capita.⁶ In the next 10 years health care spending is expected to increase further. According to the Office of the State Actuary at the Centers for Medicare and Medicaid Services, health care spending could reach 18.4% of GDP.

Health care spending encompasses significant portions of federal, state and local budgets as well as a huge private sector market. As of January 1, 2004, 14 states reported a total employer/employee premium for family coverage of more than \$900 per month according to the 2004 State Employee Benefits Survey by Workplace Economics Inc., a Washington, DC consulting firm. Fifteen states still pay the full cost of health care coverage for individual active employees, while just five states pay the full premium for family coverage. In most states, the amount paid by the employee and the state depends on the health plan and level of coverage selected by the employee. In four states - Illinois, Kansas, New Mexico, and West Virginia - the portion of the premium paid by the

employee varies by salary. Forty-three states now offer pre-tax flexible spending accounts to assist employees with medical, dental, vision, life insurance, and other expenses not covered by health plans.

In the State of Washington, the price tag to provide health care coverage to state employees increased about 20% in 2003, with both state employees and state government paying more. The Director of the Health Care Authority attributed this increase to a variety of factors, including the runaway increases in prescription drug costs, the aging workforce, and demands from doctors and other providers for higher reimbursements, and new technologies.⁷

According to Melissa Ahem, a health care economist and associate professor of health policy and administration at WSU Spokane, some of the driving forces behind rising health care costs are: consumers who want it all, from free choice of physician and loaded benefit packages to unlimited services; increasing numbers of uninsured, with associated costs for care delivered in hospital emergency rooms; increased direct-to-consumer marketing of pharmaceuticals; lack of personal responsibility for health, with more obesity, diabetes, heart disease, etc.; and the huge number of baby boomers moving rapidly toward being Medicare recipients.

Individual health care expenses are impossible to predict, but even for healthy retirees, health care can be expensive. Moreover, paying for long-term care can wreak havoc on retirement savings. Long-term nursing home care often costs \$50,000 or more per year, and Medicare covers only about 50% of seniors' regular health expenses for people 65 and older, excluding nursing home care. According to the Administration on Aging, in the year 2000 health care costs accounted for 12.6% of total spending by Americans 65 and older, more than double the 5.5% average for all age groups.⁸

N. ***Retiree Health Benefits Comparisons with Other States***

In Washington, state, K-12, and higher-ed PERS retirees, SERS retirees, and TRS retirees are allowed to continue the same health insurance by paying the same premium as their employer paid when they were active members. For a retiree who is not yet eligible for Medicare (age 65), current premiums can range from \$313 per month for a single person to \$1,024 for a member with a spouse and children.

Washington's retirees health care insurance premiums are subsidized. Typically, health insurance premiums increase as policy holders age. To pay the same premiums as younger active members, Washington State must make up the difference (i.e., subsidize retiree health benefits). In the 2003-05 biennium, according to the Office of Program Research, the state will pay close to \$223 million dollars to subsidize health care insurance for Medicare eligible and non-Medicare eligible retirees.

Allowing retirees to pay subsidized premiums to continue their health coverage is a common benefit strategy employed by other states as illustrated in the following table. Of the systems examined, CalPERS, CalSTRS, Colorado, and Ohio provided a significant payment for retiree health insurance.

Figure 16
Retiree Health Care Provisions by Select Retirement Plan

System	Pre-Medicare Eligible	Medicare Eligible
Cal PERS	Recent members need 20 yrs. service to receive 100% of state retiree medical contribution.	Member are eligible for supplemental benefits.
Cal STRS	Depends on bargaining agreement -- may be as much as full medical coverage depending on School District.	Members receive regular Medicare coverage
Colorado PERA	Members and dependents are eligible for PERA Care: subsidized medical, dental, and vision plans.	Members enrolled in Medicare part B are also eligible for PERA Care.
Florida (FRS)	Members may continue in employer provided group insurance plan and receive a subsidy of \$5 per year of service to a maximum of \$150.	Members continue to receive the \$5 per year of service subsidy to a maximum of \$150 per month
Idaho (PERSI)	Members are allowed to continue coverage in the group medical plan.	Members may purchase supplemental depending on employer.
Iowa (IPERS)	Members are allowed to continue with insurance group.	Members need to have both Parts A and B of Medicare and state becomes secondary payer.
Minnesota (MSRS)	Members are allowed to continue with insurance group (may pay into Health Care Savings Plan when employed.)	Members are eligible for a Medigap policy

System	Pre-Medicare Eligible	Medicare Eligible
Missouri (MOSERS)	Members and family are eligible to participate in any employer provided group insurance plans	Members and family are eligible to participate in any employer provided group insurance plans

System	Pre-Medicare Eligible	Medicare Eligible
Ohio (OPERS)	Majority of health premiums paid by OPERS. Remaining premiums deducted from the recipient's monthly benefit check.	Medicare part B reimbursed. Ohio plans become secondary payers.
Oregon PERS	Members may purchase group health and dental insurance.	Retiree may purchase Medicare companion insurance, state provides \$60/month subsidy
Seattle (SCERS)	Members may continue coverage at group rates	Medicare supplemental insurance available

All 50 states make health insurance available to retirees up to the age of 65 and 48 states provide coverage under the state plan for retirees age 65 or older. In 11 states, the state pays the full cost of individual coverage for retirees under age 65, who are not yet eligible for Medicare. Seventeen states pay the full premium for Medicare-eligible retirees over the age of 65. Several states reported that the retiree's share of health care premiums depends upon the date hired, date of retirement or years of service at retirement.⁹

When public employers provide health benefits they insulate their employees from these costs. While many public employees must make co-payments to their health care plans, they receive benefits of much greater value than the costs they bear. Upon retirement most public employers no longer provide such insulation, as is shown in the above table, and retirees under the age of 65 find themselves in a costly market for which they must spend a significant portion of their retirement benefits. A member with 30 years of service and a final salary of \$45,000, who retired before age 65, could spend over 1/3 of their annual retirement benefit on health care insurance premiums each year.

Conclusion

A report on the adequacy of retirement benefits is obliged to cover numerous topics. This report compared plan 1 and plan 2 designs and policies in the Public Employee's Retirement System. The report also identified some of the demographic and economic trends that affect the adequacy of retirement benefits, in particular inflation, longevity, personal savings, and health care. The report illustrated how Washington retirement benefits maintain or lose

their value over time in specific scenarios, comparing benefits among PERS 1 and PERS 2 retirees. Finally, several peer systems (states and a city) were examined for comparisons.

Highlights

1. There is no magic income replacement ratio – anywhere from 60% to 90% may be adequate depending on retirement plan provisions and personal needs. Typically, replacement ratios are based on pre-retirement salaries, and do not account for benefits such as health insurance.
2. In 2002 Americans over age 65 depended slightly more on income from work than they did on income from retirement plans, suggesting that there is a significant disconnect between behavior and the three-legged stool model, and a growing desire for a phased retirement.
3. Baby boomers in the lowest quartile of income distribution will depend almost entirely upon Social Security and Medicare benefits for nearly all their retirement income.
4. The population and workforce are aging due to long-term trends in fertility and life-expectancy, not just because of the baby boom. These trends are putting extreme pressure on pay-as-you-go benefits such as Social Security.
5. Individuals can reduce their need for retirement income by as much as five percent for each year they postpone retirement, assuming federal benefits continue to be paid as provided by current law.
6. Health care spending is currently 15.5% of the Nation's Gross Domestic Product (GDP) and is projected to continue to increase to 18.4% of GDP in 2013.
7. The cost of retirement is increasing while employer funding for retirement benefits, personal savings rates, and Social Security benefits are decreasing.
8. Retirement education leads to changes in personal savings behavior.
9. In Washington, the earlier the retirement, the greater the difference in the income replacement ratio between the Plans 1 and 2 – at age 55 initial benefits in plan 1 can replace nearly 60% of final pay but be as little as 17% of final pay in plan 2.
10. In Washington, there is a significant difference between the Plans 1 and 2 with respect to maintaining the value of the initial retirement benefit over time. The difference is magnified under the earlier retirement ages available under the Plans 1. Even in concert with Social Security and the Uniform COLA, during periods of moderate inflation PERS 1 benefits will lose purchasing power while PERS 2 benefits will retain theirs.

Endnotes

1. "Future Retirees at Risk," *American Prospect*, Alicia Munell, May 4, 2004.
2. Munell, *supra*
3. For a complete summary of the Washington's Task Force's recommendations and for statistics showing retirement eligibility by state agency, visit the DOP website at <http://hr.dop.wa.gov/publications/default.htm>.
4. Munell, Alicia H., "Population Aging: It's not Just the Baby Boom," April 2004.
5. Committee on Education and the Workforce, *Sounding the Alarm: Rising Health Care Costs Increase the Ranks of the Uninsured*.
6. *Health Affairs*, 2/11/04.
7. For a comparison of 2002 vs. 2003 employee contributions for health care costs, see the Health Care Authority's Press Release "State employees will pay more for health insurance," August 6, 2002 at www.hca.wa.gov.
8. "Retirement Blues" by Anne Richardson, *Contingencies*, September/October 2003, p.22.
9. BNA Health Care & Benefits, Vol 31. No. 17, 915-916 (April 27 2004).

Age 65 Retirement

Background

As both employers and employees had expressed long-standing concern over the normal retirement age of 65 in the PERS, TRS and SERS Plans 2/3, the initial report summarized the history relevant to the formation and design of the Plans 2/3 with a focus on aspects of plan design that affect retirement eligibility. In addition, preliminary cost estimates were provided for lowering the normal retirement age from 65 to 60 and from 65 to 62. After the initial briefing the SCPP identified the following categories of options for further study and pricing: for PERS, TRS and SERS 2/3, modify the age and service requirements for unreduced retirement and reduce the early retirement reduction factors; and for TRS 2/3 only, expand opportunities to purchase out-of-state service credit. In addition, staff was directed to consider a funding option for benefit increases that would involve a 1% Plan 3 member contribution rate increase. The subsequent report identified options within the designated categories and provided preliminary pricing for each option; it also analyzed and priced the funding option.

Committee Activity

Presentations:

September 7, 2004 - Full Committee
October 19, 2004 - Full Committee
November 9, 2004 - Executive Committee

Subgroup Activity:

October 14, 2004 - Subgroup Meeting
November 5, 2004 - Subgroup Meeting

Recommendation to Legislature

See specific tabs entitled "Rule of 90," "TRS Service Credit Purchase," and "TRS Out-of-State Service Credit Purchase."

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Select Committee on Pension Policy

Age 65 Retirement

(September 1, 2004)

Issue

Both employers and employees have expressed concern over the normal retirement age in the PERS, TRS and SERS Plans 2/3. The normal retirement age for these plans is currently set at age 65. As background information for this interim's initial work session on the issue, this report summarizes the history relevant to the formation and design of the Plans 2/3, with a focus on aspects of plan design that affect retirement eligibility. As part of this history, the report will summarize findings from the 1992 Plan 2 Retirement Age Report as Authorized by the Joint Committee on Pension Policy. This report will further examine why the Plans 2/3 have a normal retirement age of 65, and will identify the existing policies that would be impacted or changed if the retirement age were lowered. Preliminary cost estimates for lowering the retirement age from 65 to 60 and 62 are also provided.

Staff

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Members Impacted

Lowering the normal retirement age would impact active and terminated-vested ("term-vested") members of the Plans 2 and 3 of the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS) and the School Employees' Retirement System (SERS). The following table summarizes the numbers of participants in the Plans 2/3 based on the most recent actuarial valuation (using 2003 data) that would be impacted by a proposal to lower the normal retirement age:

	PERS 2	PERS 3	TRS 2	TRS 3	SERS 2	SERS 3
Active	114,876	17,411	7,507	47,109	20,748	27,226
Term-Vested	15,678	766	2,450	2,394	1,846	1,621

Current Situation

The Plans 2/3 have age-based retirement eligibility. To be eligible for normal retirement, members of the Plans 2/3 must be vested and must reach age 65. The Plans 2 are defined benefit plans, and the vesting period for these plans is five years. The Plans 3 are hybrid plans, with a defined benefit component and a defined contribution component. Plan 3 members are immediately vested in their defined contribution accounts, and become vested in the defined benefit portion of their benefit after ten years of service, or after 5 years of service if 12 months of service were accrued after attaining age 54.

History

The **Plan 1 systems** have service-based retirement eligibility and provide retirement benefits at ages prior to when members are expected to permanently leave the workforce. These plans were very costly due to the need to maintain an adequate benefit over 30 years or more. The **Plan 2** systems were created in 1977 in response to three major problems that were identified for the Plan 1 systems:

1. High cost of disability retirements in LEOFF Plan 1;
2. Increasing pressure for Cost-of-Living Adjustments (COLAs) in TRS and PERS; and
3. Increasing costs of the Plan 1 systems.

See Plan II Retirement Age Report as Authorized by the Joint Committee on Pension Policy, Washington State Legislature, October, 1992 ("1992 Report").

Due to legal constraints, the Legislature then, as now, could not reduce benefits for current employees. Instead, new systems were intended to be designed in such a way as to minimize future risks, and hence costs. The creation of the Plan 2 systems was to generate significant costs savings for the State of Washington - an estimated \$15.9 billion over a 25 year period according to projections at that time. Primarily, the savings were the result of the general fact that it is less costly to maintain an adequate retirement benefit over a shorter period of time. Also, Social Security and Medicare help augment benefits more quickly in plans with higher retirement ages.

The 1992 Report identified significant member dissatisfaction with the Plans 2. The most basic concerns appeared to be:

- Employee organizations believed their members should be able to collect a pension after completing a certain number of years of service (“service-based” retirement) rather than after permanently leaving the workforce (“age-based retirement”).
- Employees who left prior to retirement did not feel they received “reasonable value” from the retirement system, creating pressure to allow early retirement as the only way to get value.
- The interest credited to member accounts had been less than market rates and the trust fund earnings.
- Members had almost no flexibility in the form and/or timing of their benefits.

In September of 1993, the Joint Committee on Pension Policy (JCPP) proposed retirement benefit policies in connection with discussions of a possible new “**Plan 3**” to “meet the needs of employees, retirees and employers within available resources.” Joint Committee on Pension Policy Proposed Retirement Benefit Policies, September 1993. The policies inherent in the Plan 2 systems that would be continued were:

1. All state and local employees should have essentially the same retirement plans.
2. Retiree benefits should have some form and degree of protection from inflation.
3. Costs should be shared equally between employees and employers.

In addition, the JCPP would base any new plans or changes to the Plans 2 on the following additional policies:

Total Retirement Income

- Sufficient income after leaving the workforce should be from a combination of Social Security, retirement benefits and employees' savings.
- Employees must take responsibility for insuring that they have a sufficient income after retirement.

Purpose of Retirement Benefits

- Retirement benefits are intended to provide income after leaving the workforce.
- Employees who vest and leave should be provided reasonable value toward their ultimate retirement for their length of service.

Flexibility

- Retirees should have more flexibility in determining the form and timing of their benefit.
- Plan design should be as neutral as possible in its effect on employees:
 - It should not inhibit employees from changing careers or employers.
 - Employees should not be encouraged to stay in jobs they consider highly stressful.
 - Employees should not be encouraged to seek early retirement.

In 1995 the TRS Plan 3 Retirement System was created. The Plan became effective in 1996. The creation of TRS 3 was followed by creation of the SERS Plans 2/3 in 1998. These plans became effective in 2000. Finally, in 2000, an optional PERS 3 was enacted. It became effective in 2002.

The Plan 3 policies that were finally adopted by the legislature are found in RCW 41.34.010:

1. Provide a fair and reasonable value from the retirement system for those who leave public employment before retirement.
2. Increase flexibility for such employees to make transitions into other public or private sector employment.
3. Increase employee options for addressing retirement needs, personal financial planning, and career transitions.

4. Continue the legislature's established policy of having employees contribute to their retirement benefits.

Policy Analysis

In the Plans 2, the retirement age was established as the time when the member was presumed to leave the workforce. It broke with the well-established tradition within the Plans 1 of providing a retirement benefit after completion of a career. The policy rationale was that the retirement system was to provide a benefit for retirement when the member leaves the workforce and no longer draws a salary. This same philosophy was continued for the Plans 3. While members of these plans may extend their careers or pursue new career options, the retirement benefit is not paid until the member is presumed to have left the workforce.

Raising the normal retirement age in the Plans 2 and Plans 3 was in direct opposition to the national trend which for more than 20 years has been to reduce normal retirement ages. As reported to the SCPP at its May orientation by Ron Snell of the National Conference on State Legislatures, 26 of the 100 largest retirement systems allow retirement at age 62 with 5 or more years of service, and 56 systems allow normal retirement at age 60 with 5 or more years of service. Also, 56 of the largest 100 systems allow early retirement (with reduced benefits) at age 55 with 5 or more years of service.

A review of the handbooks and websites for Washington's comparative public employee retirement systems revealed a range of normal retirement ages as summarized in the following table. Normal retirement ages are considered for the purposes of this comparison to be those at which members will receive unreduced retirement benefits. Early retirement provisions are not included within this comparison. The following table summarizes the age and service requirements for normal retirement in the open plans within the comparative systems.

Normal Retirement Age Comparisons	
Retirement System	Normal Retirement Age/ Years of Service
CalPERS	63*
CalSTERS	60/1
Colorado (PERA)	50/30, 60/20, 65/5
Florida Retirement System	62/6, Any age/30
Idaho (PERSI)	65/5
Iowa (IPERS)	65, 62/20, Rule of 88
Minnesota State Retirement System	66 (65 if born before 1938)
Missouri (MOSERS)	65/4 (active), 65/5, 60/15, Rule of 80 (at least age 48)
Ohio PERS	65/5, (Traditional and Combined Plans), 55 (Member Directed Plan)
Oregon Public Service Retirement Plan (for those hired after 8/28/03)	65, 58/30
City of Seattle	62/5, 60/20, Rule of 80 from age 52-59, Any age/30

*2.5% benefit factor at age 63, 2.0% benefit at 55/5

Both employers and employees in Washington have expressed concern over the normal retirement age in the Plans 2/3. At the May 18, 2004 Orientation, "age 65 retirement" was listed as the number 3 priority for the SCPP. Also, "working until age 65" is one of the issues that the SCPP forwarded from last year for study during the 2004 interim.

Why age 65?

The 1992 Report identified age 65 as the generally accepted full (or normal) retirement age as established by Social Security. Today the full retirement age under Social Security is increasing. As explained on the Social Security Administration's website, www.ssa.gov, Americans are living longer, healthier lives and can expect to spend more time in retirement than their parents and grandparents did. See also Adequacy of Benefit, Report to the SCPP, June 2004 for more information on the aging workforce. Today Social Security's full retirement age of 65 applies only to those born in 1937 or earlier. For those born after 1937, a full retirement age schedule has been adopted. The later the birthday, the later the full retirement age. For example, those who are born in 1960 and later have a full retirement age of 67. Persons covered by Social Security can retire as early as 62, but their benefits are reduced to take into account the longer period of time they will receive them.

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Plan 2/3 Tradeoffs

The Plan 2/3 designs incorporated two benefits that were not available to members of the Plans 1:

1. An annual cost-of-living adjustment after one year of retirement based on the CPI-Seattle to a maximum of 3%; and

2. Removal of the 60% cap on average final compensation (AFC).

These benefits reflected a tradeoff. Members would have shorter retirement periods than they would have had under the service-based Plans 1, but would enjoy increased financial security. Not only would Plan 2/3 members' purchasing power be protected throughout retirement by a stable and predictable COLA, but also members of the Plans 2/3 would be rewarded for working into their later years by allowing them to earn an increased monthly retirement benefit.

Figures 1-4 compare PERS 1 and PERS 2 plan provisions based on a hypothetical retiree with salary increases of 4.5% per year prior to retirement, inflation at 3.5% annual rate (actuarial assumption) and social security (SSI) beginning at age 66 when the member would receive an unreduced benefit. These figures illustrate that while PERS 2 can't replace as great a share of salary as PERS 1 at early retirement ages, it can at later ages, and at all ages it maintains a more constant benefit.

Figure 1
PERS & SSI Benefits as a % of Final Pay
After 25 Years of Service at Age 55

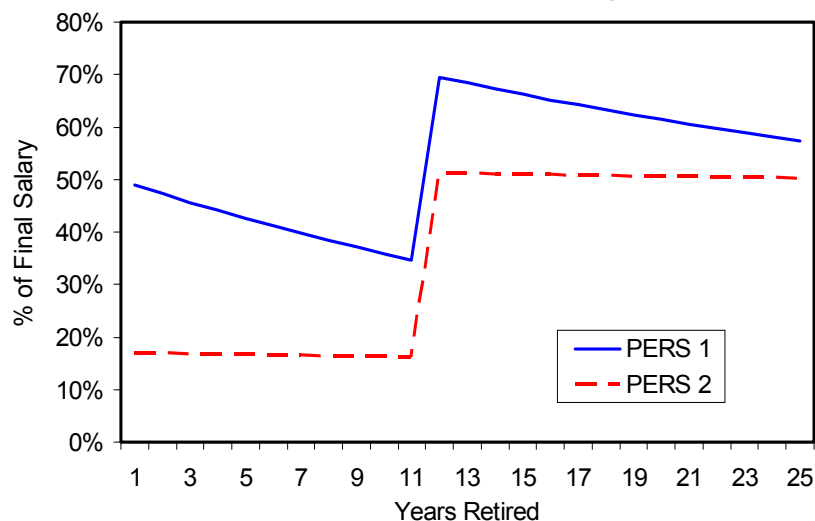


Figure 2
PERS & SSI Benefits as a % of Final Pay
After 30 Years of Service at Age 55

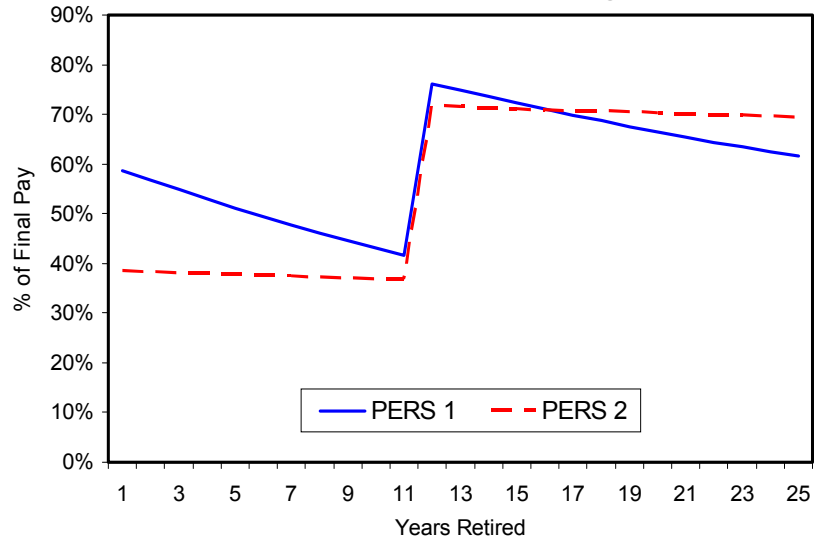


Figure 3
PERS & SSI Benefits as a % of Final Pay
After 30 Years of Service at Age 60

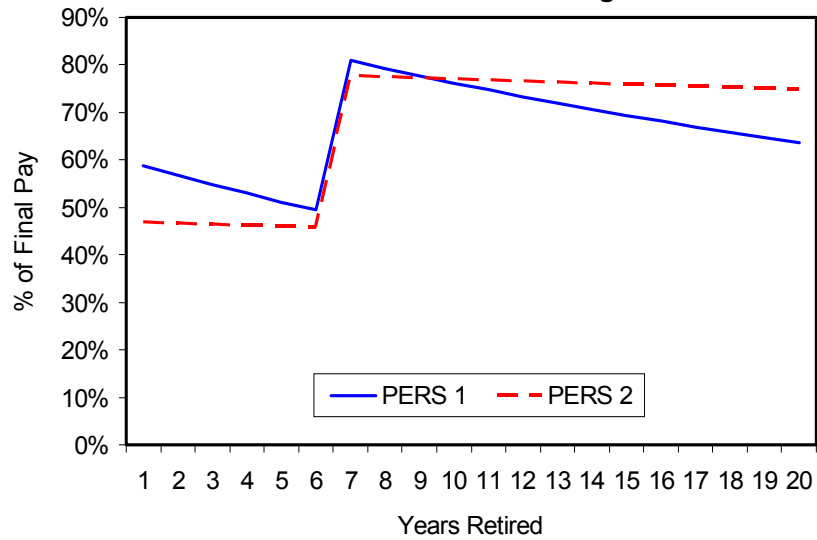
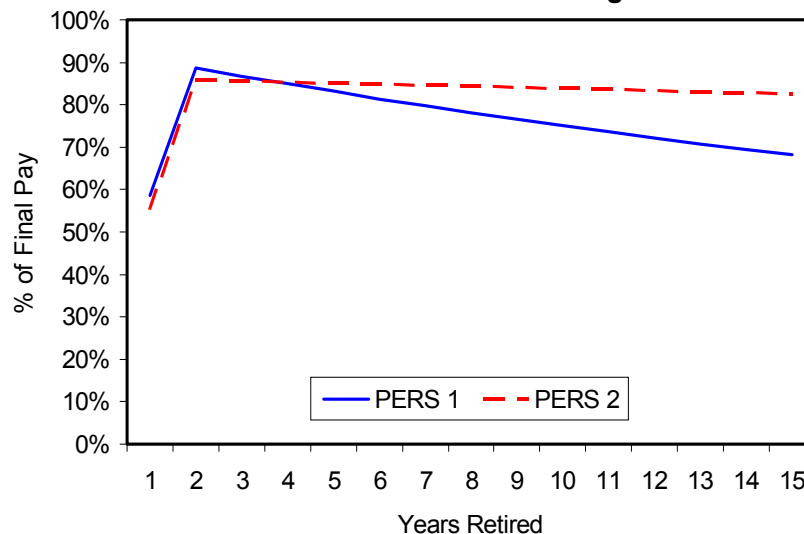


Figure 4
PERS & SSI Benefits as a % of Final Pay
After 30 Years of Service at Age 65



“Golden Handcuffs”

The Plans 2 adopted what is known as a “golden handcuffs” design. This means that they provide relatively little value for employees who leave service prior to retirement and they provide great value to employees who work until age 65. Under this type of design, the most commonly sought way for members with significant years of service to obtain value from this type of retirement plan without remaining in the system until age 65 is to seek a lowering of the retirement age so they can receive an immediate benefit on termination. This can be accomplished through early retirement windows or plan amendments that permanently reduce the retirement age.

In contrast, members of service-based plans commonly seek opportunities to be rehired after retirement. This has been true in Washington state, as Plan 1 members and employers have taken the lead on initiatives to allow post-retirement employment.

Early Retirement

The service-based Plans 1 provided for normal retirement upon the fulfillment of one of the following:

1. five years of service and attainment of age 60;
2. 25 years of service and attainment of age 55; and
3. 30 years of service (at any age).

There are no provisions for early retirement of PERS 1 members, as the Plans 1 are designed to allow normal retirement upon completion of a career.

As discussed in the history section, the Plans 2/3 were designed to discourage early retirement and encourage working until age 65. Originally, the Plans 2 provided for early retirement, but completely at the member's cost. Members could seek early retirement after 20 years of service and attainment of age 55, with the benefit being actuarially reduced from age 65. Later (in 1991) a compromise was added whereby members who worked 30 years (instead of 20) and reached age 55 could qualify for "alternate early retirement." The reduction for alternate early retirement is not completely born by the member, as it involves a 3% per year reduction from age 65 rather than the full actuarially equivalent reduction.

The following table from the Department of Retirement Systems' website shows the approximate effect of the early retirement reductions:

PERS, TRS and SERS Plan 2/3 Early Retirement Reduction Factors		
Age at Retirement	20-29 Years of Service Credit, Benefit as % of Age 65 Benefit	30 Years of Service Credit or More, Benefit as % of Age 65 Benefit
55	37%	70%
56	40%	73%
57	43%	76%
58	49%	79%
59	55%	82%
60	61%	85%

Age at Retirement	20-29 Years of Service Credit, Benefit as % of Age 65 Benefit	30 Years of Service Credit or More, Benefit as % of Age 65 Benefit
61	67%	88%
62	73%	91%
63	82%	94%
64	91%	97%
65	100%	100%

Provisions for early and alternate early retirement were carried forward into the design of the Plans 3. As a general matter, the Plan 2/3 members who retire early experience a significantly reduced income replacement ratio for their defined benefit. See Adequacy of Benefits Report to the SCPP, June 2004. Term-vested members of Plan 3 who leave employment early were given additional flexibility to protect their accrued benefit without taking early retirement: Plan 3 members with at least 20 service credit years who separate from service will have their pension benefits increased by 0.25% per month, or approximately 3% for each year they delay receiving benefits until age 65. Also, Plan 3 members can plan for early retirement at their own expense by increasing their member contributions. Conversely, in down markets (assuming they are physically able), Plan 3 members can work past 65 and continue to improve their benefits.

Portability

Portability refers to the ability to maintain the value of retirement benefits earned for past employment when changing jobs prior to retirement. Members of the Plans 2 are discouraged by the plan design from changing careers to new jobs covered by other retirement systems unless those systems are included in Washington's portability statute. The portability statute allows members to combine service credit with that earned in certain other Washington state retirement systems in order to qualify for retirement. Those systems include TRS, PERS, the Statewide City Employees' Retirement System, SERS, the Washington State Patrol Retirement System, Plan 2 of the Law Enforcement Officers' and Firefighters' Retirement System, the city employees' retirement systems for Seattle, Tacoma and Spokane, and starting July 1, 2006, the Public Safety Employees' Retirement System.

The Plans 3 repeat most of the design features of the Plans 2, but add more portability due to the fact that members are immediately vested in the defined contribution portion of their benefit. Thus Plan 3 members can leave prior to vesting, work for any employer, and still receive 100% of the value of their employee contributions plus earnings. Also, as mentioned above, members with 20 service credit years may leave service and have their pension benefits increased 0.25% per month, or approximately 3% for each year they delay receiving benefits until age 65 (“indexed term-vested benefit”).

Pension plans may also address portability of benefits by authorizing members to **purchase service credit** for years of work that the individual would otherwise lose. For example, a teacher may work only two years in a state that requires five years of work before the teacher will be eligible, sometime in the future, for a pension. If the teacher moves to another state with a service-based retirement plan that requires 30 years of service to receive a full pension, then at 28 years of service, that teacher could purchase the service credit for the two additional years of teaching in the first state and have the 30 years needed to receive a full pension.

Washington’s Teachers’ Retirement Plans currently allow members to elect to use service credit earned in an out-of-state retirement systems solely for the purpose of determining the time at which the member may retire. The benefit is actuarially reduced to recognize the difference between the age a member would have first been able to retire based on service in Washington and the member’s retirement age. See RCW 41.32.065. Out-of-state service may also be used to meet alternate early retirement requirements, which would result in the use of a 3% per year early retirement reduction factor (ERF) instead of an actuarial ERF.

Example: A member age 55 with 25 years of Washington state service credit and 5 years of out-of-state service credit is assessed 10 years worth of reductions (since he/she needs 10 years to reach age 65). The member can use 5 years of out-of-state service credit to qualify for an alternate early retirement, but the 5 years does not count as membership service for benefit purposes. Instead DRS would use actuarial early retirement reductions for the first 5 of the 10 years and the 3% alternate early retirement reduction for the remaining five years. The effect on the monthly benefit is shown below:

$$\begin{aligned} &2\% \times 25 \text{ years} \times \$6,500 \text{ (AFC)} = \$3,250 \\ &\times .61 \text{ (\% of benefit using actuarial ERF)} = \$1,982.50 \\ &\times .85\% \text{ (\% of benefit using 3\% ERF)} = \mathbf{\$1,685.12} \end{aligned}$$

The out-of-state service-credit-purchase approach to portability has not been incorporated into the PERS and SERS Plans. However in the PERS and SERS Plans 2/3, service credit purchases can be used to offset other reductions in benefits. See SSB 6251/HB 2535, Ch. 172, Laws of 2004) that was passed to allow these Plan 2/3 members who apply for early retirement to make a one-time purchase of up to five years of additional service credit at actuarial cost. While the service credit is not membership service, it can be used to help offset the benefit reductions for early retirement.

Alternative Approaches Considered Prior to Adoption of the Plans 3

The Joint Committee on Pension Policy studied five approaches to changing the Plans 2 prior to the creation of the Plans 3:

- 1a) lower the normal retirement age, and 1b) reduce early retirement reduction factors;
- 2) increase career mobility and allow limited payments prior to normal retirement;
- 3) allow employees the opportunity to choose their normal retirement age with the employee contribution reflecting the cost of the plan chosen;
- 4) create a new hybrid plan; and
- 5) create a new defined contribution plan.

The first three approaches would modify the existing Plan 2 design. The last two approaches would require new Plans 3.

*Approach No. 1A: **Lower Normal Retirement Age***

The 1992 Report examined the option of lowering the normal retirement ages for the Plans 2 to the Plan 1 retirement ages (age 60 with five years of service, age 55 with 25 years or at any age with 30 years). At that time the option was identified as a “high cost” item that would cause contribution rates to increase substantially. Less costly variations on this proposal were also considered: a 3-year reduction in the normal retirement age and a 5-year reduction. According to surveys conducted at the time, the majority of Plan 2 members expressed a willingness to pay higher employee contribution rates of between 2 and 2.5% in exchange for normal retirement at age 60 instead of 65.

Lowering the normal retirement age, however, was ultimately rejected. The 1992 Report identified two major ways that lowering the normal retirement age would depart from Plan 2 policies:

- retirement benefits would no longer be paid only at an age when employees are generally presumed to permanently leave the workforce; and
- retirees might not receive an adequate initial benefit (due to less service) and the purchasing power of the initial benefits would not be as well protected for the longer retirement period.

*Approach No. 1(B): Significantly **Reduce Early Retirement Reduction Factors***

This approach would have kept the Plan 2 normal retirement age, but lowered the early retirement adjustment factors from a full actuarial adjustment (about 7-9 % per year) to 1% per year. The eligibility criteria for early retirement under this alternative would have stayed the same: age 55 with 20 years of service for PERS and TRS 2. The change would have allowed eligible Plan 2 members to retire up to 10 years prior to the “normal” retirement age without a significant reduction in benefits. The following examples show the impact on the annual pension benefit of the actuarial early reduction factor (ERF) as compared to a 1% ERF:

TRS 2 member retiring at age 55 using actuarial ERF:

Age 65 - 55 = 10 years

63% reduction

$\$40,000 \times 25 \text{ years} \times 2\% = \$20,000 \times .37$

Annual Benefit = **\$7,400**

TRS 2 member retiring at age 55 using 1% ERF:

Age 65 - 55 = 10 years

10% reduction

$\$40,000 \times 25 \text{ years} \times 2\% = \$20,000 \times .90$

Annual Benefit = **\$18,000**

Again, this alternative was identified as “high cost” in the 1992 Report. The same two departures from Plans 2 policies were identified for this alternative as for lowering the retirement age: retirement benefits would be paid prior to when employees were expected to permanently leave the workforce, and it would be

less certain that the benefit would be adequate to maintain the retiree's standard of living throughout the period of retirement. This alternative was ultimately rejected.

*Approach No. 2: **Increase Career Mobility and Allow Limited Payments Prior to Retirement***

Several options were studied under this approach. The first option was to provide **automatic increases for vested benefits**. Upon separation from covered employment with 20 or more years of service, Plan 2 members who leave their contributions with the system would have their benefit increased each year during the period between termination and retirement. The annual increase would be based on the same formula as the Plan 2 COLA - the change in the Seattle CPI, up to 3% per year. The member would not begin receiving the benefit until the normal retirement age of 65.

The purpose of this benefit was to help ensure that long-service employees who leave covered positions receive a benefit at the normal retirement age that has increased to keep up with inflation. It would reduce the financial penalty incurred by employees who move to positions in the private sector, or other positions not covered by Washington's portability statutes. This benefit was ultimately adopted for the defined benefit component of the Plans 3.

Another alternative under this approach was to **expand the coverage of the portability statute** to include LEOFF 2 and the Seattle, Tacoma and Spokane employee retirement systems. This would make it possible for employees to change jobs to a wider range of public sector positions while maintaining value for their early years of service. These changes were ultimately adopted as amendments to RCW 41.54.010.

Another alternative was studied that would **credit member contributions with interest** at a rate which more closely reflects market rate interest. This would be accomplished by methods such as crediting accounts with the average return earned by medium or long-term government bonds, or the five-year average returns earned by the State Investment Board. The main purpose of this change would be to increase the perceived value of the retirement system for younger employees and to respond to the most frequent active members' complaint at that time. It would also increase the amount of benefits employees might be able to collect early in connection with job transitions as

well as the amount such members could withdraw at retirement. Ultimately this alternative was rejected as a Plan 2 modification but was largely incorporated into the Plans 3 as the defined contribution component of these hybrid plans.

An “**optional job/retirement transition benefit**” was considered for Plan 2 members with twenty or more years of service. These members would be paid a monthly income from their accumulated contributions under two circumstances:

1. 50% of pay for up to two years, while training for a new career or on a sabbatical break (job transition benefit); or
2. up to 50% of pay, or the member’s accrued benefit, when leaving the work force between age 60 and 65 (retirement transition benefit for PERS and TRS Plans 2 only).

The member would receive a reduced benefit at retirement to reflect the member contributions paid out before normal retirement age. The reduced benefit could be actuarially equivalent or could be partially subsidized. Both benefits would permit a member to receive payment of all or part of their member contributions prior to retirement, without destroying their eligibility for a benefit provided by the employer. The income from this benefit could also “bridge” the period between age 60 and when the retiree receives Social Security. This alternative was not adopted.

A “**phased retirement**” benefit was also considered. Under this proposal, Plan 2 members could work half-time and at the same time collect 50% of their accrued retirement allowance, for up to three years prior to full retirement. The members would have to be age 62 or older and enter into a contract for half-time service with their employers. At full retirement, the member’s benefit would be reduced to adjust for payments made prior to the normal retirement age. If a full actuarial reduction were made, there would be no cost to the system. This approach was not adopted.

Finally, the 1992 Report considered allowing those in Plan 2 the option to **withdraw** their **member contributions plus interest at retirement** as had been allowed for members of TRS 1. The retirement allowance would be actuarially reduced to reflect the value of the withdrawn contributions. This alternative was not implemented.

Approach No. 3: Allow Employees to Choose Between Three Different Retirement Plans, Each with Benefits Similar to the Plan 2 Systems, Except for Different Normal Retirement Ages

Under this approach, three new retirement plans would be created that were similar to PERS 2, but each would have a different normal retirement age: Tier 3A - age 65; Tier 3B - age 60; and Tier 3C - age 55. Employees would have the option of selecting which plan they wished to be covered under, but would pay higher contribution rates for service earned under the plans with earlier retirement ages. Benefits would be portable, and employees would be given frequent opportunities to move between the different plans. This approach was rejected. Like the alternatives in Approach No. 1, this approach would depart from Plan 2 policies in that retirement benefits would no longer be paid only at an age when employees were generally presumed to permanently leave the workforce, retirees who elected the age 55 plan may not receive an adequate initial benefit (due to service), and the purchasing power of the initial benefit would not be as well-protected for the longer retirement period.

Approach No. 4: Replace the Plan 2 Systems with New “Split Plans” which Reflect Typical Private Sector Federal Employees Retirement System Plan Design.

This approach involved creating a new retirement system which would include both a defined benefit pension and a defined contribution account. The design would provide a balance between the policy goals promoted by defined benefit plans and defined contribution plans. The hybrid plan model was ultimately adopted for the Plans 3.

Approach No. 5: Replace Plan 2 Systems with Defined Contribution Plan

This approach would provide a source of retirement savings which would be highly portable for employees who switched jobs prior to normal retirement age. However employees would take on the risk of poor investment returns, and employees who provided identical periods of service would receive different retirement benefits. In other words, this approach was deemed more flexible, but riskier. The responsibility for the long-term financial security would be shifted largely to the retiree. Management of risks associated with longevity (i.e., the danger of outliving one's benefit) would also shift to the retiree. The 1992 Report indicated that for a given level of funding, retirees would receive smaller benefits in a defined contribution plan than under the defined benefit design. Employer contribution rates, however, would be stable and predictable. This approach was not adopted.

In summary, the Joint Committee on Pension Policy studied many alternatives to the Plan 2 design prior to recommending the creation of the Plans 3. Despite the fact that employees had identified the Plan 2 retirement age as one of their top concerns, the designs of the Plans 2 and 3 retained the primary policy of withholding the retirement pension until the age at which the member is presumed to permanently leave the workforce - that is, age 65. Lowering the normal retirement age would depart from that established policy.

Estimated Cost of Lowering the Normal Retirement Age in the Plans 2/3

Lowering the normal retirement age in the Plans 2/3 will impact the required actuarial contribution rates as shown below. As a result of higher contribution rates, increases in funding expenditures are also projected.

Estimated Cost of Lowering Retirement Age from 65 to 60

	PERS		SERS		TRS		Total
<i>Increase in Contribution Rates</i>							
Employee <i>(Plan 2 Only)</i>	2.71%		2.85%		2.85%		
Employer	2.71%		2.85%		2.85%		
<i>Costs (in millions):</i>							
2005-2007 Biennium							
State:							
General Fund	\$	82.5	\$	40.2	\$	174.0	\$ 296.7
Non-General Fund		<u>136.3</u>		<u>0.0</u>		<u>0.0</u>	<u>136.3</u>
Total State	\$	218.8	\$	40.2	\$	174.0	\$ 433.0
Local Government		194.0		35.6		35.7	265.3
Total Employer		412.8		75.8		209.7	698.3
Employee	\$	382.0	\$	19.5	\$	9.2	\$ 410.7
2005-2030 25 Years							
State:							
General Fund	\$	2,322.6	\$	1,191.4	\$	4,734.0	\$ 8,248.0
Non-General Fund		<u>3,832.5</u>		<u>0.0</u>		<u>0.0</u>	<u>3,832.5</u>
Total State	\$	6,155.1	\$	1,191.4	\$	4,734.0	\$ 12,080.5
Local Government		5,458.4		1,055.5		969.8	7,483.7
Total Employer		11,613.5		2,246.9		5,703.8	19,564.2
Employee	\$	11,517.8	\$	112.8	\$	23.3	\$ 11,653.9

Estimated Cost of Lowering Retirement Age from 65 to 62

	PERS	SERS	TRS	Total
<i>Increase in Contribution Rates</i>				
Employee (Plan 2 Only)	1.70%	1.64%	1.53%	
Employer	1.70%	1.64%	1.53%	
<i>Costs (in millions):</i>				
2005-2007 Biennium				
State:				
General Fund	\$ 51.8	\$ 23.2	\$ 93.4	\$ 168.4
Non-General Fund	85.4	0.0	0.0	85.4
Total State	\$ 137.2	\$ 23.2	\$ 93.4	\$ 253.8
Local Government	121.6	20.6	19.1	161.3
Total Employer	258.8	43.8	112.5	415.1
Employee	\$ 239.6	\$ 11.3	\$ 4.9	\$ 255.8
2005-2030 25 Years				
State:				
General Fund	\$ 1,457.0	\$ 685.9	\$ 2,541.5	\$ 4,684.4
Non-General Fund	2,404.2	0.0	0.0	2,404.2
Total State	\$ 3,861.2	\$ 685.9	\$ 2,541.5	\$ 7,088.6
Local Government	3,424.3	608.5	520.2	4,553.0
Total Employer	7,285.5	1,294.4	3,061.7	11,641.6
Employee	\$ 7,224.7	\$ 64.8	\$ 12.3	\$ 7,301.8

Funding Policies of the Plans 2/3

Reducing the normal retirement age for the Plans 2/3 may have implications for the funding policies of the plans. With respect to **cost-sharing**, current funding policy presumes that costs should be shared equally between employers and employees. See Joint Committee on Pension Policy proposed policies for new Plan 3, September 1993. As shown in the previous section of this report, reducing the normal retirement age is a high-cost proposition. Thus, in order to facilitate enactment of such a proposal, there may be some need to adjust the policy to accommodate the increased cost. For example the SCPP has seen at least one proposal that would increase the Plan 3 employee contribution rate to pay for increased benefits.

The other significant funding policy implication relates to liability for benefits payable as the result of past service. By lowering the retirement age, **liabilities for past-service benefits are increased** due to the fact that their cost cannot be recovered over as long of a period of time. As provided in the actuarial

funding chapter, Chapter 41.45 RCW, all benefits for Plan 2 and 3 members are to be funded over the working lives of those members and paid by the taxpayers who receive the benefits of those members' services. See RCW 41.45.010(4). For those members who have worked part of their careers, the benefits they have already earned must be paid for over the remainder of their careers. If the length of these careers is shortened due to the creation of a lower normal retirement age, liabilities are increased at the same time that the period to collect the funds to pay for the benefit improvement is shortened (a "double whammy").

Proposals Affecting Retirement Eligibility

Many proposals have been made to the SCPP for study during the 2004 interim. Because some of them specifically affect retirement eligibility, they may be viewed as alternatives or companions to options for reducing the normal retirement age. Estimated costs for these proposals are not provided as part of this initial report. The proposals include:

- Normal retirement with an age/service combination of 85 (rule of 85).
- Normal retirement at any age with 35 or 30 years of service.
- Eliminating the actuarial reduction factors for early retirement and replacing them with a uniform 3% per year reduction factor.
- Increasing the Plan 3 defined benefit from 1% to 1.5% to address adequacy concerns.
- Changing the Plan 3 vesting period from 10 to 5 years.
- Eliminating the early retirement reduction factor for permanent disability.
- Expanding the indexed term-vested benefit (currently 3% per year for Plan 3 members with 20 years of service credit).
- Providing for the purchase of up to 10 years of service credit for teaching in American public schools (state and federal) using a cost formula that is less than actuarial cost.
- Merging Plans 2 and 3 into a new plan.

If, as the result of this background briefing, the SCPP decides to pursue options related to normal retirement eligibility within the Plans 2/3, the above proposals may be viewed as possible options for further discussion that may be added to the most obvious options of reducing the normal retirement age from 65 to some lower age (e.g. 62 or 60).

Conclusion

Service-based plans usually result in earlier retirements, higher costs, and pressures to allow post-retirement employment. Age-based plans usually result in later retirement ages, lower costs, and pressures to allow retirement at earlier ages. Washington started with service or career-based plans and moved to age-based plans in 1977 in order to reduce costs. Lowering the normal retirement age would be consistent with national trends and would help address long-standing employer and employee concerns with the retirement age.

Lowering the normal retirement age would also be a departure from the policy that is currently the cornerstone of the Plans 2/3 - that is, to provide a retirement benefit when the member is presumed to have permanently left the workforce and that is at or near the age when Social Security and Medicare will pick up a significant portion of retiree costs. Lowering the normal retirement age in the Plans 2/3 would move toward a retirement philosophy that is more career-based than age-based, and would result in significantly increased costs.

Select Committee on Pension Policy

Age 65 Retirement Options

(October 12, 2004)

Issue

Both employers and employees have expressed concern over the normal retirement age in the Public Employees' Retirement System (PERS) Plans 2/3, the Teachers' Retirement System (TRS) Plans 2/3 and the School Employees' Retirement System (SERS) Plans 2/3. The normal retirement age for these plans is currently set at age 65. After its work session and briefing on this issue on September 7, 2004, the SCPP identified the following categories of options for further study and pricing: for PERS, TRS and SERS Plans 2/3, modify the age and service requirements for unreduced retirement and reduce the early retirement reduction factors; and for TRS 2/3 only, expand opportunities to purchase out-of-state service credit. In addition, staff was to directed to consider what a 1% Plan 3 member contribution rate increase would provide in terms of funding benefit increases.

Staff

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Members Impacted

The following table summarizes the numbers of participants in the Plans 2/3 based on the most recent actuarial valuation (using 2003 data).

	PERS 2	PERS 3	TRS 2	TRS 3	SERS 2	SERS 3
Active	117,262	17,548	7,637	47,263	21,504	27,710
Term-Vested	16,089	770	2,493	2,418	1,902	1,648

Current Situation

With respect to **retirement eligibility**, the Plans 2/3 are age-based plans. To be eligible for normal retirement, members of the Plans 2/3 must be vested and must reach age 65. The Plans 2 are defined benefit plans, and the vesting period for these plans is five years. The Plans 3 are hybrid plans, with a defined benefit component and a defined contribution component. Plan 3 members are immediately vested in their defined contribution accounts, and become vested in the defined benefit portion of their benefit after ten years of service, or after 5 years of service if 12 months of service were accrued after attaining age 54.

With respect to the **early retirement reduction factors**, it is important to distinguish early retirement and “alternate early retirement.” Currently in the Plans 2/3, members may seek early retirement after 20 years of service and attainment of age 55 with the benefit being actuarially reduced from age 65. The actuarial reduction factors are applied so that the early retirement does not cost the retirement system more than it would have had the member worked until the specified normal retirement age. In other words, since the benefit is being paid over a longer period of time, the member must take a lower benefit that is worth the same in assumed total benefit dollars as if it had been taken at normal retirement age.

Members who work 30 years (instead of 20) and reach age 55 may qualify for alternate early retirement. Alternate early retirement is not cost-neutral, as it involves a 3% per year reduction rather than the full actuarially equivalent reduction. In other words, longer service is rewarded in that the member who works thirty years is not required to take a benefit that is equivalent to the benefit the member would have received at age 65. Instead, the member takes some reduction for the fact that the pension is being paid over a longer period of time, but the total benefit is greater than if the member had waited until age 65.

The following table from the Department of Retirement Systems’ website shows the approximate effect of the current early retirement reduction factors on the retirement benefit received.

PERS, TRS and SERS Plan 2/3
Early Retirement Reduction Factors

Age at Retirement	20-29 Years of Service Credit, Benefit as % of Age 65 Benefit	30 Years of Service Credit or More, Benefit as % of Age 65 Benefit
55	37%	70%
56	40%	73%
57	43%	76%
58	49%	79%
59	55%	82%
60	61%	85%
61	67%	88%
62	73%	91%
63	82%	94%
64	91%	97%
65	100%	100%

With respect to the opportunity to purchase **out-of-state service credit** in the TRS Plans 2/3, members may currently elect to use service credit earned in an out-of-state retirement system solely for the purpose of determining the time at which the member will retire. The benefit is actuarially reduced to recognize the difference between the age a member would have first been able to retire based on service in Washington and the member's retirement age. See RCW 41.32.065. Out-of -state service may also be used to meet alternate early retirement requirements, which would result in the use of a 3% per year early retirement reduction factor (ERRF) instead of an actuarial ERRF.

Example: A member age 55 with 25 years of Washington state service credit and 5 years of out-of-state service credit is assessed 10 years worth of reductions (since he/she needs 10 years to reach age 65). The member can use 5 years of out-of-state service credit to qualify for an alternate early retirement, but the 5 years does not count as membership service for benefit purposes. Instead the Department of Retirement Systems (DRS) would use actuarial early retirement reductions for the first 5 of the 10 years and the 3% alternate early retirement reduction for the remaining 5 years. The effect on the monthly benefit is shown below:

$$\begin{aligned} & 2\% \times 25 \text{ years} \times \$6,500 \text{ (AFC)} - \$3,250 \\ & \times .61 \text{ (\% of benefit using actuarial ERRF)} = \$1,982.50 \\ & \times .85\% \text{ (\% of benefit using 3\% ERRF)} = \mathbf{\$1,685.12} \end{aligned}$$

Another way to utilize out-of-state retirement benefits in TRS is to purchase additional benefits with a rollover from an out-of-state retirement plan. The resulting contribution to the member reserve is actuarially converted to a monthly benefit at the time of retirement. See RCW 41.32.067. This cash-based approach has been in effect since 1992, and seeks to avoid the pension costs associated with giving lifelong benefits at a reduced cost.

Finally, with respect to **Plan 3 member contributions**, the current situation is that members of the Plans 3 contribute 100% of their employee contributions into their own defined contribution accounts. The defined benefit portion of the Plan 3 benefit (which represents one-half of the Plan 2 defined benefit) is funded solely by employers. Thus, currently, Plan 3 member contributions are not used to fund benefit increases involving the defined benefit.

Options that Expand Opportunities for an Unreduced Retirement in the Plans 2/3

Option 1: "Rule of 90" for unreduced retirement

A "rule of 90" would allow members to receive an unreduced retirement benefit when they reach any combination of age and service that totals 90. For example, an employee who became a plan member at age 20 could retire at age 55 with 35 years of service. Similarly, a plan member who began working at age 30 could retire at age 60 with a full benefit. Those who become plan members at age 40 or later would not benefit from the rule of 90, as there would be no combination of age and service that could result in a full retirement benefit earlier than age 65, the current normal retirement age for the Plans 2/3.

The following table illustrates the operation of a rule of 90 for any retirement system.

Illustration of Rule of 90			
Age of Hire	Years of Service	Retire Age	Age Plus Years of Service
20	35	55	90
22	34	56	90
24	33	57	90
26	32	58	90
28	31	59	90
30	30	60	90
32	29	61	90
24	28	62	90
36	27	63	90
38	26	64	90
40	25	65	90

This approach would move toward a more career-based retirement benefit in that younger workers would be rewarded for long-term public service by receiving an unreduced retirement benefit prior to the time at which they would normally be expected to leave the workforce. The cost of a lifetime benefit for such individuals would be higher because the benefit would be paid over a longer period of time.

As shown below, members of the TRS would benefit from a Rule of 90 more than members of SERS or PERS because they have lower entry ages and longer service years.

Relative Value of Rule of 90 Among Retirement Systems				
System	Average Age	Average Service	Average Age at Hire	"Rule of 90" Age
TRS	44	11	33	61.5
PERS	45	10	35	62.5
SERS	46	7	39	64.5

Providing unreduced retirement benefits for the Plans 2/3 under a "rule of 90" will impact the required actuarial contribution rates as shown below. As a result of higher contribution rates, increases in funding expenditures are also projected.

Option 1: Rule of 90

	PERS	SERS	TRS	Total
Increase in Contribution Rates				
Employee (Plan 2 Only)	0.69%	0.52%	0.93%	
Employer	0.69%	0.52%	0.93%	
<i>Cost (In Millions)</i>				
2005-2007 Biennium				
State:				
General Fund	\$21.1	\$7.5	\$56.8	\$85.4
Non-general Fund	34.7	0.0	0.0	34.7
Total State	\$55.8	\$7.5	\$56.8	\$120.1
Local Government	49.4	6.5	11.6	67.5
Total Employer	105.2	14.0	68.4	187.6
Employee	\$74.9	\$3.6	\$3.0	\$81.5
2005-2030 25 Years				
State:				
General Fund	\$591.7	\$218.1	\$1,544.4	\$2,354.2
Non-general Fund	975.7	0.0	0.0	975.7
Total State	\$1,567.4	\$218.1	\$1,544.4	\$3,329.9
Local Government	1,389.6	193.5	316.2	1,899.3
Total Employer	2,957.0	411.6	1,860.6	5,229.2
Employee	\$1,690.7	\$20.7	\$7.5	\$1,718.9

Option 2: Unreduced retirement at age 60 with twenty years of service

This approach retains some aspects of age-based retirement, but allows a lower normal retirement age for members who have served at least twenty years. Again, this approach moves toward a more career-based retirement benefit and away from the strict adherence to age-based retirement that currently exists in the Plans 2/3.

Providing unreduced retirement benefits for members of the Plans 2/3 that have reached age 60 with twenty years of service credit will impact the required actuarial contribution rates as shown below. As a result of higher contribution rates, increases in funding expenditures are also projected.

**Option 2: Unreduced Retirement at
Age 60 with 20 Years of Service**

	PERS	SERS	TRS	Total
Increase in Contribution Rates				
Employee (Plan 2 Only)	0.89%	1.05%	1.02%	
Employer	0.89%	1.05%	1.02%	
<i>Cost (In Millions)</i>				
2005-2007 Biennium				
State:				
General Fund	\$27.1	\$14.7	\$62.3	\$104.1
Non-general Fund	44.7	0.0	0.0	44.7
Total State	\$71.8	\$14.7	\$62.3	\$148.8
Local Government	63.6	13.0	12.8	89.4
Total Employer	135.4	27.7	75.1	238.2
Employee	\$96.6	\$7.2	\$3.3	\$107.1
2005-2030 25 Years				
State:				
General Fund	\$762.6	\$438.0	\$1,693.9	\$2,894.5
Non-general Fund	1,258.5	0.0	0.0	1,258.5
Total State	\$2,021.1	\$438.0	\$1,693.9	\$4,153.0
Local Government	1,792.4	388.7	346.9	2,528.0
Total Employer	3,813.5	826.7	2,040.8	6,681.0
Employee	\$2,180.8	\$41.7	\$8.2	\$2,230.7

Options that Reduce the Early Retirement Reduction Factors

Option 3: Uniform 3% ERRF

As discussed in the Age 65 Retirement Report dated September 1, 2004, the Plans 2/3 currently have a design that discourages early retirement. Those who retire early - age 55 with 20 years of service - must have their benefit actuarially reduced so as to avoid higher costs to the pension system. As a result, there is no economic benefit to retiring early. Alternatively, those who retire at 55 with 30 years of service must take a reduction for leaving early, but

they are rewarded for longer service by having some of the reduction covered by the plan. This is a kind of “compromise” between the need for an age-based plan to save costs, and the desire to reward those who have worked for many years.

A uniform 3% ERRF would eliminate the actuarial reduction for early retirement benefits and replace it with an across-the-board 3% reduction for anyone who leaves at age 55 with twenty years of service. [The thirty-year service distinction would become moot.] This option would move the plan away from the current age-based retirement philosophy in the Plans 2/3 and would encourage more early retirement. Because the total benefit taken at early retirement would not be actuarially equivalent to the benefit taken at normal retirement (i.e. it would be greater), there is an additional cost to the plan. This kind of option would be more helpful to members of PERS and SERS due to the fact that those plans have older entry ages and higher turnover.

A uniform 3% ERRF will impact the required actuarial contribution rates for the Plans 2/3 as shown below. As a result of higher contribution rates, increases in funding expenditures are also projected.

Option 3: Uniform 3% ERRF				
	PERS	SERS	TRS	Total
Increase in Contribution Rates				
Employee (Plan 2 Only)	1.07%	1.33%	1.41%	
Employer	1.07%	1.33%	1.41%	
<i>Cost (In Millions)</i>				
2005-2007 Biennium				
State:				
General Fund	\$32.6	\$18.5	\$86.1	\$137.2
Non-general Fund	53.7	0.0	0.0	53.7
Total State	\$86.3	\$18.5	\$86.1	\$190.9
Local Government	76.6	16.5	17.7	110.8
Total Employer	162.9	35.0	103.8	301.7
Employee	\$116.2	\$9.1	\$4.5	\$129.8

2005-2030 25 Years

State:

General Fund	\$917.1	\$554.6	\$2,341.9	\$3,813.6
Non-general Fund	1,513.2	0.0	0.0	1,513.2
Total State	\$2,430.3	\$554.6	\$2,341.9	\$5,326.8
Local Government	2,155.2	492.1	479.7	3,127.0
Total Employer	4,585.5	1,046.7	2,821.6	8,453.8
Employee	\$2,621.7	\$52.5	\$11.4	\$2,685.6

Option 4: 3% ERRF triggered at age 60 with 20 years of service

One way to reduce the plan costs associated with the uniform 3% ERRF would be to raise the age at which the 3% ERRF would be triggered from 55 to 60. This option would, however, still impact the required actuarial contribution rates for the Plans 2/3 as shown below. As a result of higher contribution rates, the increases in funding expenditures are also projected.

**Option 4: 3% ERRF Triggered at
Age 60 with 20 Years of Service**

	PERS	SERS	TRS	Total
Increase in Contribution Rates				
Employee (Plan 2 Only)	0.50%	0.62%	0.61%	
Employer	0.50%	0.62%	0.61%	
<i>Cost (In Millions)</i>				
2005-2007 Biennium				
State:				
General Fund	\$15.3	\$8.7	\$37.2	\$61.2
Non-general Fund	25.2	0.0	0.0	25.2
Total State	\$40.5	\$8.7	\$37.2	\$86.4
Local Government	35.9	7.6	7.7	51.2
Total Employer	76.4	16.3	44.9	137.6
Employee	\$54.3	\$4.3	\$2.0	\$60.6

2005-2030 25 Years

State:

General Fund	\$428.4	\$258.8	\$1,013.0	\$1,700.2
Non-general Fund	707.3	0.0	0.0	707.3
Total State	\$1,135.7	\$258.8	\$1,013.0	\$2,407.5
Local Government	1,007.2	229.3	207.2	1,443.7
Total Employer	2,142.9	488.1	1,220.2	3,851.2
Employee	\$1,224.9	\$24.5	\$4.9	\$1,254.3

Expand Opportunities to Purchase Out-of-State Service Credit in the TRS Plans 2/3

Currently there is limited opportunity to utilize out-of-state service credit in the Plans 2/3 of the Teachers' Retirement System. As described above in the section entitled "Current Situation," Plan 2/3 members may elect to apply teaching service credit earned in an out-of-state retirement system solely for the purpose of determining the time at which the member may retire. This provision has been in effect since 1991.

Another way to utilize out-of-state retirement benefits in TRS is to purchase additional benefits with a rollover from an out-of-state retirement plan. The resulting contribution to the member reserve is actuarially converted to a monthly benefit at the time of retirement. See RCW 41.32.067. This cash-based approach has been in effect since 1992, and seeks to avoid the pension costs associated with giving lifelong benefits at a reduced cost.

The proposed expansion of service credit purchase opportunities in the Plans 2/3 would involve a more direct approach that would allow members to actually receive service credit in TRS for time worked in out-of-state systems. The proposal is focused on the TRS system alone and not the other Washington State retirement systems, presumably to address what in the past have been identified as recruitment and retention issues within the teaching profession.

Washington's Department of Personnel (DOP) has identified other public professions and job categories with recruitment and retention issues. They include the following: Therapist/Consultants, Ergonomists, Industrial Hygienists, Pressure Vessel Inspectors, Registered Nurses, Nursing Consultants (Institutional), Dentists, Physicians, Pharmacists, Pharmacist Investigators, AGO Investigators/Analysts, Investigators (Eastern Washington),

Public Health Advisors, Radiation Health Physicists, Curators and IT Positions (with specialized programming requirements). See attached e-mail correspondence from Dorothy Gerard of DOP. Thus adoption of this option could lead to “leapfrogging”, i.e. members and/or employers wanting the same or better benefits for other plans in other retirement systems.

Option 5: Allow members with at least 5 years of Washington State service to purchase up to 10 years of out-of-state service credit.

In developing and pricing this option, certain assumptions were made and various limitations were imposed. They are as follows:

- This option assumes a 5-year window to purchase the service credit upon completion of 5 years of service in TRS Plan 2 or 3. Since Plan 3 has 10-year vesting, implementation of this option would require a provision allowing for a refund of contributions for purchasing out-of-state service credit in the event that the member fails to vest.
- The member must not be currently receiving or currently eligible to receive a retirement benefit from another state that includes the out-of-state service credit to be purchased.
- The amount of service credit to be purchased cannot exceed 10 years or the amount of in-state service, whichever is less.
- In computing the cost of the out-of-state service credit, the interest rate is the assumed actuarial rate of return.
- This option assumes a cost that is computed very much as if the service had occurred in Washington. The Plan 2 member must pay both the employer and employee contributions with interest. The contribution rates are tied to the entry age normal cost rate instead of actual rates for the period in order to provide more consistency in pricing the service credit purchases.
- Plan 3 members would pay only the employer contribution plus interest since they receive only one-half the defined benefit (and their defined benefit is funded only by the employer). It would be necessary to provide for a refund of contributions to members who waive the defined benefit as authorized in RCW 41.32.837.

- The service credit purchased would be membership service, and may be used to qualify the member for retirement.

The amount of actual out-of-state service that members have in other systems and for which they may seek to purchase Washington service credit is unknown, as the Office of the State Actuary (OSA) has no direct access to data that is currently being collected for this purpose. This is a significant variable in determining the cost of this option. In order to make reasonable assumptions along these lines, the OSA has utilized data from an informal survey conducted by Mr. Lee Goeke of the Executive Committee of the SCPP. According to Mr. Goeke, the survey results account for about 13% of the teachers employed within the state, or 6,850 TRS members. The average out-of-state service for this group was 1.58 years. The ten-year cap lowered the average to 1.34 years for this sample.

It should be noted in the discussion of this option that purchasing out-of-state service credit is a complicated topic with many policy and fiscal implications. The topic is broad enough to be a separate issue worthy of study and discussion in the manner of other large issues that have been part of the SCPP's work plan during this interim. Many of the assumptions made for pricing this particular option were made by the OSA staff - not to usurp the SCPP as policy makers, but to provide some reasonable parameters that would allow for pricing this option in time for the October 19, 2004 meeting.

Allowing service credit for time outside the plan at less than actuarial cost will impact the required actuarial contribution rates of the TRS Plans 2/3 as shown below. As a result of higher contribution rates, increases in funding expenditures are also projected.

Expand Opportunities to Purchase Out-Of-State Service Credit in TRS Plans 2/3		
Increase in Contribution Rates	TRS	
	Low Estimate	High Estimate
Employee (Plan 2 Only)	0.09%	0.16%
Employer	0.09%	0.16%

<i>Cost (In Millions)</i>	TRS	
	Low Estimate	High Estimate
2005-2007 Biennium		
State:		
General Fund	\$5.5	\$9.7
Non-general Fund	\$0.0	\$0.0
Total State	\$5.5	\$9.7
Local Government	\$1.1	\$1.9
Total Employer	\$6.5	\$11.6
Employee	\$0.3	\$0.5
2005-2030 25 Years		
State:		
General Fund	\$149.3	\$265.4
Non-general Fund	\$0.0	\$0.0
Total State	\$149.3	\$265.4
Local Government	\$30.4	\$54.1
Total Employer	\$179.7	\$319.5
Employee	\$0.7	\$1.3

Examples of TRS Payments for 2 years of Out-of-State Service Credit:

Plan 2 Member: $\$50,000 \times 11.80\% \times (1+1.08) = \mathbf{\$12,272}$

Plan 3 Member: $\$50,000 \times 5.9\% \times (1+1.08) = \mathbf{\$6,136}$

Assumptions and Methods:

The \$50,000 is pay for a sample member. The average was around \$47,000, but it varies by plan. The 11.80% for Plan 2 is the 2002 Entry Age Normal Cost (EANC), which excludes gain-sharing. The 11.80% for Plan 2 includes both the member and employer contribution. The 5.90% for Plan 3 is half the 11.80% and represents the employer EANC. The purchase of the first year has no interest. The second year interest rate is 8%. Additional years would have included compound interest.

Funding Option - 1% Plan 3 Member Contribution

In addition to pricing the above options, staff was also directed at the September 7, 2004 SCPP meeting to determine how much funding a 1% Plan 3 member contribution would provide for possible benefit enhancements in the Plans 2/3. This “funding option” was specifically raised in connection with proposed options 1 and 2 discussed above (“rule of 90” and unreduced retirement at age 60 with 20 years of service).

This funding approach should be examined in the context of existing funding policy in order to assess the impacts of the proposal. The actuarial funding chapter (Chapter 41.45 RCW) codifies certain funding policies that are currently applicable to the Plans 2/3. They include the following:

- (1) to continue to fully fund the plans 2/3;
- (2) to establish predictable long-term employer contribution rates which will remain a relatively constant proportion of future state budgets; and
- (3) to fund all benefit increases over the working lives of the members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members’ service.

The other major funding policy applicable to the plans 2/3 can be gleaned from examining the records of the Joint Committee on Pension Policy (JCPP). The Plan II Retirement Age Report (October 1992) identified certain dissatisfaction with the Plans 2 and was followed by the JCPP’s 1993 Proposed Retirement Benefit Policies for the possible new Plans 3. The JCPP proposal included continuation of the Plan 2 funding policy that costs should be shared equally between employees and employers. This **cost-sharing policy** was implemented in both the plan design for the Plans 3 and in the funding practices adopted by the legislature over time.

In addition, the Plans 2/3 were designed to include an **equivalent employer-provided benefit**. As provided in the JCPP’s 1993 Proposed Policies, the Plans 3 were intended to continue the Plan 2 policy that all state and local employees should have essentially the same retirement plans. The way to keep the Plan 3 benefits equivalent to Plan 2 benefits was to assure that the employer-provided defined benefit was same in both plans. Thus both Plan 2 and Plan 3 employers fund a defined benefit that is equal to 1% of average final

compensation (AFC). The commitment to Plan 2/3 equivalency carries over into the **structure of the retirement trust funds** for the Plans. The Plan 2/3 trust funds are combined for PERS, TRS and SERS respectively. See e.g. RCW 43.84.092(4)(a) and RCW 41.45.050(4), (5) and (6).

If a specific option to improve benefits in the Plans 2/3 were adopted, along with legislation mandating a 1% Plan 3 member contribution to help pay for the benefit, the following impacts would occur. This approach to funding would require a significant restructuring of the design for the Plans 2/3 as well as changes to basic funding policies.

- There would be a deviation from the cost-sharing policy. Plan 3 employees would be paying more for an improvement to the defined benefit than employers would pay for that same plan improvement.
- Plan 3 members would be paying more than Plan 2 members for the same employer-provided benefit.
- The Plans 2/3 would no longer be essentially equivalent. PERS members who chose to transfer to Plan 3 may regret their decisions and there may be both legal and political pressure to provide some kind of relief to those Plan 3 members. Those who are mandated into the Plans 3 may seek recourse for having to pay for increased Plan 2 benefits, especially if contribution rates for Plan 2 members are not affected.
- In order for the Plan 3 member contributions to be used to offset the costs of the benefit improvements, it would be necessary to provide for the payment of Plan 3 member contributions into the defined benefit trust fund. Currently, all Plan 3 member contributions are paid into the member's defined contribution accounts.
- If 1% of Plan 3 member contributions were mandated into the trust fund, there is a question about whether these funds should be part of a combined Plan 2/3 trust fund. The trust funds may have to be split. This would also deviate from the existing policy constraint of maintaining equivalent benefits for all public employees.
- The payment of a mandatory 1% Plan 3 member contribution could impact the permissible annual amounts that Plan 3 members may contribute to their defined contribution accounts.

- Significant amendments would be required to current plan provisions.
- Significant administrative and communication impacts would be generated.

A mandatory 1% Plan 3 member contribution would generate the following amounts in dollars for TRS, SERS and PERS.

Funding Option - 1% Plan 3 Member Contributions				
	PERS	SERS	TRS	Total
Increase in Contribution Rates				
Employee (Plan 3 Only)	1.00%	1.00%	1.00%	
Employer	0.00%	0.00%	0.00%	
<i>Cost (In Millions)</i>				
2005-2007 Biennium				
Employee (Plan 3 Only)	\$32.0	\$18.0	\$62.6	\$112.6
2005-2030 25 Years				
Employee (Plan 3 Only)	\$1,799.8	\$740.4	\$1,973.5	\$4,513.7

Select Committee on Pension Policy

Age 65 Retirement

Probability of Service Retirement

(October 18, 2004)

Option 1: Rule of 90

Kicker Added to Retirement Probability						
	PERS Male	PERS Female	SERS Male	SERS Female	TRS Male	TRS Female
Age						
55	0.35	0.29	0.30	0.30	0.30	0.30
56	0.35	0.29	0.30	0.30	0.30	0.30
57	0.35	0.29	0.30	0.30	0.30	0.30
58	0.29	0.22	0.30	0.30	0.30	0.30
59	0.29	0.22	0.30	0.30	0.30	0.30
60	0.29	0.22	0.30	0.30	0.30	0.30
61	0.29	0.22	0.25	0.30	0.30	0.30
62	0.29	0.16	0.25	0.20	0.30	0.20
63	0.11	0.16	0.25	0.20	0.25	0.20
64	0.11	0.16	0.25	0.20	0.25	0.20

The kicker is added to the retirement probability when first eligible for the Rule of 90. For each year after the year first eligible, 25% of the kicker is added.

Option 2: Unreduced Retirement at Age 60 with 20 Years of Service

Age	Current Assumptions						Age 60 with 20 Years of Service								
	PERS	PERS	SERS	SERS	TRS	TRS	PERS	PERS	PERS	SERS	SERS	SERS	TRS	TRS	TRS
	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male
							>=20			>=20			>=20		
	<30	>=30	<30	>=30	<30	>=30	<20	<30	>=30	<20	<30	>=30	<20	<30	>=30
54			0.02	0.04	0.05	0.08				0.02	0.02	0.04	0.05	0.05	0.08
55	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
56	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
57	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
58	0.10	0.14	0.10	0.14	0.05	0.08	0.10	0.10	0.14	0.10	0.10	0.14	0.05	0.05	0.08
59	0.10	0.14	0.10	0.14	0.20	0.30	0.10	0.10	0.14	0.10	0.20	0.14	0.20	0.38	0.30
60	0.14	0.21	0.14	0.21	0.40	0.60	0.14	0.22	0.21	0.14	0.20	0.21	0.40	0.63	0.60
61	0.14	0.21	0.14	0.21	0.30	0.45	0.14	0.22	0.21	0.14	0.45	0.21	0.30	0.47	0.45
62	0.33	0.50	0.33	0.50	0.30	0.45	0.33	0.49	0.50	0.33	0.30	0.50	0.30	0.38	0.45
63	0.26	0.39	0.26	0.39	0.60	0.90	0.26	0.44	0.39	0.26	0.38	0.39	0.60	0.80	0.90
64	0.79	0.90	0.79	0.90	0.50	0.50	0.79	0.90	0.90	0.79	0.90	0.90	0.50	0.50	0.50
65	0.52	0.52	0.52	0.52	0.50	0.50	0.52	0.52	0.52	0.52	0.52	0.52	0.50	0.50	0.50
66	0.30	0.30	0.30	0.30	0.50	0.50	0.30	0.30	0.30	0.30	0.30	0.30	0.50	0.50	0.50
67	0.22	0.22	0.22	0.22	0.50	0.50	0.22	0.22	0.22	0.22	0.22	0.22	0.50	0.50	0.50
68	0.22	0.22	0.22	0.22	0.50	0.50	0.22	0.22	0.22	0.22	0.22	0.22	0.50	0.50	0.50
69	0.26	0.26	1.00	1.00	1.00	1.00	0.26	0.26	0.26	1.00	1.00	1.00	1.00	1.00	1.00
70+	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Option 2: Unreduced Retirement at Age 60 with 20 Years of Service

Age	Current Assumptions						Age 60 with 20 Years of Service								
	PERS	PERS	SERS	SERS	TRS	TRS	PERS	PERS	PERS	SERS	SERS	SERS	TRS	TRS	TRS
	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female
							>=20			>=20			>=20		
	<30	>=30	<30	>=30	<30	>=30	<20	<30	>=30	<20	<30	>=30	<20	<30	>=30
54			0.02	0.04	0.03	0.05				0.02	0.04	0.04	0.03	0.05	0.05
55	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.07	0.07	0.05	0.08	0.08
56	0.05	0.07	0.05	0.07	0.10	0.15	0.05	0.05	0.07	0.05	0.07	0.07	0.10	0.15	0.15
57	0.05	0.07	0.05	0.07	0.10	0.15	0.05	0.05	0.07	0.05	0.07	0.07	0.10	0.15	0.15
58	0.05	0.07	0.05	0.07	0.10	0.15	0.05	0.05	0.07	0.05	0.07	0.07	0.10	0.15	0.15
59	0.05	0.07	0.05	0.07	0.15	0.23	0.05	0.05	0.07	0.05	0.25	0.07	0.15	0.34	0.23
60	0.14	0.21	0.14	0.21	0.20	0.30	0.14	0.27	0.21	0.14	0.20	0.21	0.20	0.31	0.30
61	0.18	0.27	0.18	0.27	0.30	0.45	0.18	0.24	0.27	0.18	0.35	0.27	0.30	0.33	0.45
62	0.30	0.45	0.30	0.45	0.30	0.45	0.30	0.52	0.45	0.30	0.35	0.45	0.30	0.50	0.45
63	0.26	0.39	0.26	0.39	0.50	0.75	0.26	0.44	0.39	0.26	0.44	0.39	0.50	0.75	0.75
64	0.82	0.90	0.82	0.90	0.50	0.50	0.82	0.90	0.90	0.82	0.90	0.90	0.50	0.50	0.50
65	0.49	0.49	0.49	0.49	0.30	0.30	0.49	0.49	0.49	0.49	0.49	0.49	0.30	0.30	0.30
66	0.30	0.30	0.30	0.30	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.30	0.25	0.25	0.25
67	0.26	0.26	0.26	0.26	0.25	0.25	0.26	0.26	0.26	0.26	0.26	0.26	0.25	0.25	0.25
68	0.26	0.26	0.26	0.26	0.40	0.40	0.26	0.26	0.26	0.26	0.26	0.26	0.40	0.40	0.40
69	0.22	0.22	1.00	1.00	1.00	1.00	0.22	0.22	0.22	1.00	1.00	1.00	1.00	1.00	1.00
70+	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Option 3: Uniform 3% ERRF

Age	Current Assumptions						Uniform 3% ERF					
	PERS	PERS	SERS	SERS	TRS	TRS	PERS	PERS	SERS	SERS	TRS	TRS
	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male
	<30	>=30	<30	>=30	<30	>=30	<30	>=30	<30	>=30	<30	>=30
54			0.02	0.04	0.05	0.08			0.04	0.04	0.08	0.08
55	0.05	0.07	0.05	0.07	0.05	0.08	0.07	0.07	0.07	0.07	0.08	0.08
56	0.05	0.07	0.05	0.07	0.05	0.08	0.07	0.07	0.07	0.07	0.08	0.08
57	0.05	0.07	0.05	0.07	0.05	0.08	0.07	0.07	0.07	0.07	0.08	0.08
58	0.10	0.14	0.10	0.14	0.05	0.08	0.14	0.14	0.14	0.14	0.08	0.08
59	0.10	0.14	0.10	0.14	0.20	0.30	0.14	0.14	0.14	0.14	0.30	0.30
60	0.14	0.21	0.14	0.21	0.40	0.60	0.21	0.21	0.21	0.21	0.60	0.60
61	0.14	0.21	0.14	0.21	0.30	0.45	0.21	0.21	0.21	0.21	0.45	0.45
62	0.33	0.50	0.33	0.50	0.30	0.45	0.50	0.50	0.50	0.50	0.45	0.45
63	0.26	0.39	0.26	0.39	0.60	0.90	0.39	0.39	0.39	0.39	0.90	0.90
64	0.79	0.90	0.79	0.90	0.50	0.50	0.90	0.90	0.90	0.90	0.50	0.50
65	0.52	0.52	0.52	0.52	0.50	0.50	0.52	0.52	0.52	0.52	0.50	0.50
66	0.30	0.30	0.30	0.30	0.50	0.50	0.30	0.30	0.30	0.30	0.50	0.50
67	0.22	0.22	0.22	0.22	0.50	0.50	0.22	0.22	0.22	0.22	0.50	0.50
68	0.22	0.22	0.22	0.22	0.50	0.50	0.22	0.22	0.22	0.22	0.50	0.50
69	0.26	0.26	1.00	1.00	1.00	1.00	0.26	0.26	1.00	1.00	1.00	1.00
70	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Option 3: Uniform 3% ERRF

	Current Assumptions						Uniform 3% ERF					
	PERS	PERS	SERS	SERS	TRS	TRS	PERS	PERS	SERS	SERS	TRS	TRS
	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female
Age	<30	>=30	<30	>=30	<30	>=30	<30	>=30	<30	>=30	<30	>=30
54			0.02	0.04	0.03	0.05			0.04	0.04	0.05	0.05
55	0.05	0.07	0.05	0.07	0.05	0.08	0.07	0.07	0.07	0.07	0.08	0.08
56	0.05	0.07	0.05	0.07	0.10	0.15	0.07	0.07	0.07	0.07	0.15	0.15
57	0.05	0.07	0.05	0.07	0.10	0.15	0.07	0.07	0.07	0.07	0.15	0.15
58	0.05	0.07	0.05	0.07	0.10	0.15	0.07	0.07	0.07	0.07	0.15	0.15
59	0.05	0.07	0.05	0.07	0.15	0.23	0.07	0.07	0.07	0.07	0.23	0.23
60	0.14	0.21	0.14	0.21	0.20	0.30	0.21	0.21	0.21	0.21	0.30	0.30
61	0.18	0.27	0.18	0.27	0.30	0.45	0.27	0.27	0.27	0.27	0.45	0.45
62	0.30	0.45	0.30	0.45	0.30	0.45	0.45	0.45	0.45	0.45	0.45	0.45
63	0.26	0.39	0.26	0.39	0.50	0.75	0.39	0.39	0.39	0.39	0.75	0.75
64	0.82	0.90	0.82	0.90	0.50	0.50	0.90	0.90	0.90	0.90	0.50	0.50
65	0.49	0.49	0.49	0.49	0.30	0.30	0.49	0.49	0.49	0.49	0.30	0.30
66	0.30	0.30	0.30	0.30	0.25	0.25	0.30	0.30	0.30	0.30	0.25	0.25
67	0.26	0.26	0.26	0.26	0.25	0.25	0.26	0.26	0.26	0.26	0.25	0.25
68	0.26	0.26	0.26	0.26	0.40	0.40	0.26	0.26	0.26	0.26	0.40	0.40
69	0.22	0.22	1.00	1.00	1.00	1.00	0.22	0.22	1.00	1.00	1.00	1.00
70+	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Option 4: 3% ERRF Triggered at Age 60 with 20 Years of Service

Age	Current Assumptions						3% ERRF at Age 60 with 20 Years of Service								
	PERS	PERS	SERS	SERS	TRS	TRS	PERS	PERS	PERS	SERS	SERS	SERS	TRS	TRS	TRS
	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male	Male
								>=20			>=20			>=20	
	<30	>=30	<30	>=30	<30	>=30	<20	<30	>=30	<20	<30	>=30	<20	<30	>=30
54			0.02	0.04	0.05	0.08				0.02	0.02	0.04	0.05	0.05	0.08
55	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
56	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
57	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
58	0.10	0.14	0.10	0.14	0.05	0.08	0.10	0.10	0.14	0.10	0.10	0.14	0.05	0.05	0.08
59	0.10	0.14	0.10	0.14	0.20	0.30	0.10	0.10	0.14	0.10	0.14	0.14	0.20	0.30	0.30
60	0.14	0.21	0.14	0.21	0.40	0.60	0.14	0.21	0.21	0.14	0.21	0.21	0.40	0.60	0.60
61	0.14	0.21	0.14	0.21	0.30	0.45	0.14	0.21	0.21	0.14	0.21	0.21	0.30	0.45	0.45
62	0.33	0.50	0.33	0.50	0.30	0.45	0.33	0.50	0.50	0.33	0.50	0.50	0.30	0.45	0.45
63	0.26	0.39	0.26	0.39	0.60	0.90	0.26	0.39	0.39	0.26	0.39	0.39	0.60	0.90	0.90
64	0.79	0.90	0.79	0.90	0.50	0.50	0.79	0.90	0.90	0.79	0.90	0.90	0.50	0.50	0.50
65	0.52	0.52	0.52	0.52	0.50	0.50	0.52	0.52	0.52	0.52	0.52	0.52	0.50	0.50	0.50
66	0.30	0.30	0.30	0.30	0.50	0.50	0.30	0.30	0.30	0.30	0.30	0.30	0.50	0.50	0.50
67	0.22	0.22	0.22	0.22	0.50	0.50	0.22	0.22	0.22	0.22	0.22	0.22	0.50	0.50	0.50
68	0.22	0.22	0.22	0.22	0.50	0.50	0.22	0.22	0.22	0.22	0.22	0.22	0.50	0.50	0.50
69	0.26	0.26	1.00	1.00	1.00	1.00	0.26	0.26	0.26	1.00	1.00	1.00	1.00	1.00	1.00
70+	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Option 4: 3% ERRF Triggered at Age 60 with 20 Years of Service

Age	Current Assumptions						3% ERF at Age 60 with 20 Years of Service								
	PERS	PERS	SERS	SERS	TRS	TRS	PERS	PERS	PERS	SERS	SERS	SERS	TRS	TRS	TRS
	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female	Female
								>=20			>=20			>=20	
	<30	>=30	<30	>=30	<30	>=30	<20	<30	>=30	<20	<30	>=30	<20	<30	>=30
54			0.02	0.04	0.03	0.05				0.02	0.02	0.04	0.03	0.03	0.05
55	0.05	0.07	0.05	0.07	0.05	0.08	0.05	0.05	0.07	0.05	0.05	0.07	0.05	0.05	0.08
56	0.05	0.07	0.05	0.07	0.10	0.15	0.05	0.05	0.07	0.05	0.05	0.07	0.10	0.10	0.15
57	0.05	0.07	0.05	0.07	0.10	0.15	0.05	0.05	0.07	0.05	0.05	0.07	0.10	0.10	0.15
58	0.05	0.07	0.05	0.07	0.10	0.15	0.05	0.05	0.07	0.05	0.05	0.07	0.10	0.10	0.15
59	0.05	0.07	0.05	0.07	0.15	0.23	0.05	0.05	0.07	0.05	0.07	0.07	0.15	0.23	0.23
60	0.14	0.21	0.14	0.21	0.20	0.30	0.14	0.21	0.21	0.14	0.21	0.21	0.20	0.30	0.30
61	0.18	0.27	0.18	0.27	0.30	0.45	0.18	0.27	0.27	0.18	0.27	0.27	0.30	0.45	0.45
62	0.30	0.45	0.30	0.45	0.30	0.45	0.30	0.45	0.45	0.30	0.45	0.45	0.30	0.45	0.45
63	0.26	0.39	0.26	0.39	0.50	0.75	0.26	0.39	0.39	0.26	0.39	0.39	0.50	0.75	0.75
64	0.82	0.90	0.82	0.90	0.50	0.50	0.82	0.90	0.90	0.82	0.90	0.90	0.50	0.50	0.50
65	0.49	0.49	0.49	0.49	0.30	0.30	0.49	0.49	0.49	0.49	0.49	0.49	0.30	0.30	0.30
66	0.30	0.30	0.30	0.30	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.30	0.25	0.25	0.25
67	0.26	0.26	0.26	0.26	0.25	0.25	0.26	0.26	0.26	0.26	0.26	0.26	0.25	0.25	0.25
68	0.26	0.26	0.26	0.26	0.40	0.40	0.26	0.26	0.26	0.26	0.26	0.26	0.40	0.40	0.40
69	0.22	0.22	1.00	1.00	1.00	1.00	0.22	0.22	0.22	1.00	1.00	1.00	1.00	1.00	1.00
70+	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Contribution Rate Setting

Background

The Select Committee on Pension Policy (SCPP) identified “contribution rate stability” as one of the top four priorities of the SCPP at the May 2004 orientation.

Committee Activity

Presentation:

July 13, 2004 - Full Committee

Recommendation to Legislature

None. Elements of this issue were included under the “Deferred Rate Increases” proposal.

Staff Contact

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Select Committee on Pension Policy

Contribution Rate Setting

(July 2, 2004)

Issue

The Select Committee on Pension Policy (SCPP) identified “contribution rate stability” as one of the top four priorities of the SCPP at the May 2004 Orientation.

Staff

Matt Smith, State Actuary
360-753-9144

Members Impacted

A change to the rate setting process would impact members differently depending on their retirement plan. The member contribution rate for PERS and TRS Plans 1 is fixed in statute at 6%. Currently, LEOFF Plan 1 is fully funded, so no member contributions are required at this time. Prior to 2000, the LEOFF 1 member rate was fixed at 6%.

Members of PERS, TRS and SERS Plans 3 do not contribute to the defined benefit portion of Plan 3 (the employer provided life annuity). Members in these plans, therefore, would not be impacted.

Members of PERS, TRS, SERS, LEOFF Plans 2 and the WSP retirement system share in the cost of their retirement benefit with their employer. Therefore, a change to the rate setting process would impact Plan 2 and WSP members. As of September 30, 2002, there were 162,664 members in the Plans 2 and WSP combined. Of this count, 116,939 come from PERS Plan 2.

Current Situation

Provisions governing the current contribution rate setting process are codified under the Actuarial Funding Chapter - Chapter 41.45 RCW. In summary, these provisions provide for the systematic actuarial funding of the state retirement systems. Biennial actuarial valuations performed on odd-year valuation dates are the basis for contribution rate recommendations to the Pension Funding Council (PFC). Contribution rates adopted by the PFC in September of even-numbered years, referred to as “basic rates,” are effective during the ensuing biennium subject to revision by the Legislature. Temporary and “supplemental rates” are charged in addition to the basic rates to fund the cost of benefit enhancements that are granted by the Legislature in between the 2-year basic rate cycles.

History

The Pension Funding Reform Act, Chapter 273, Laws of 1989, established a systematic actuarial funding process for the state retirement systems. Contribution rates under the initial Funding Reform Act were scheduled to remain in place for a 6-year period. Additionally, the current funding policy was established including the goal to fully amortize the plan 1 unfunded liability by June 30, 2024. Prior to the Funding Reform Act, pension contributions were subject to a discretionary appropriation by the Legislature.

Chapter 519, Laws of 1993, changed the 6-year cycle established in 1989 to a 2-year cycle. Beginning September 30, 1994, contribution rates were scheduled for adoption in September of even-numbered years and revisited every two years thereafter.

Chapter 11, Laws of 2001, E2, codified the asset smoothing method under law. The method was changed from a 3-year method, determined by the State Actuary, to a 4-year smoothing period established under law.

Chapter 11, Laws of 2003, E1, modified the asset smoothing method - allowing up to an 8-year smoothing period depending on the magnitude of the deviation between the actual investment return and what was assumed for the period.

Chapter 93, Laws of 2004, created a new asset smoothing corridor for valuations performed after July 1, 2004. Following the effective date of the new law, the actuarial or “smoothed” value of assets must not exceed 130% nor drop below 70% of the market value of assets at the valuation date.

Actuarial Terms

The following table defines key actuarial terms that will be used throughout this report:

Term	Definition
<i>Actuarial Cost Method</i>	A procedure for allocating the actuarial present value of projected benefits and expenses to time periods, usually in the form of a normal cost and an actuarial accrued liability - “the funding method.”
<i>Normal Cost</i>	Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year - “the cost of benefits in the current year under the funding method.”
<i>Entry Age Normal Cost</i>	Normal cost calculated under the Entry Age Normal actuarial cost method. The normal cost is determined by the contribution rate which, if collected from a new member’s entry date to retirement, would fully prefund their projected benefit - “long-term annual cost of the plan if all assumptions are realized (no short term gains or losses.)”

Term	Definition
<i>Amortization of Unfunded Actuarial Accrued Liability (UAAL)</i>	The method of funding the difference between the actuarial accrued liability and the actuarial value of assets, usually determined under the funding policy - “method for paying off unfunded prior service liability.”
<i>Asset Valuation Method</i>	A method selected by the actuary for smoothing the effects of short-term volatility in the market value of assets - “the asset smoothing technique.”
<i>Funding Policy</i>	The plan sponsor’s policy for determining the periodic contribution or cost for a plan - including the level of cost sharing between the employee and employer.

Policy Analysis

Current Funding Policy and Methods

The funding policy of the Legislature is contained in Chapter 41.45 RCW - Actuarial Funding of State Retirement Systems. RCW 41.45.010 outlines the intent to achieve four funding goals. Three of the goals listed in that section specifically pertain to the issue of rate stability and are listed below:

- to continue to fully fund the plans 2/3;
- to fully amortize the total costs of the plans 1 not later than June 30, 2024; and
- to establish predictable long-term employer contribution rates which will remain a relatively constant proportion of future state budgets.

Certain actuarial methods were selected in order to attain these funding goals. These methods are listed below:

Current Method	Description
<i>Actuarial Cost Method</i>	Aggregate cost method for plans 2/3. Modified Entry Age Normal method for plans 1.

Current Method	Description
<i>Normal Cost</i>	Aggregate normal cost for plans 2/3. The normal cost is shared equally between the plan 2 employee and plan 2 employer.
<i>Amortization of UAAL</i>	The plan 2/3 employer normal cost is used for the plan 1 employer normal cost. The plan 1 employee normal cost is fixed at 6%. No UAAL under aggregate cost method.
<i>Asset Valuation Method</i>	Plan 1 UAAL must be amortized by June 30, 2024 as a level percentage of projected system payroll. Up to an 8-year smoothing period depending on the magnitude of the deviation between the actual and assumed investment return for the period. Smoothed value of assets may not exceed 130% nor drop below 70% of the market value of assets at the valuation date - “the smoothing corridor.”

The aggregate cost method was selected to satisfy the goal of fully funding the plans 2/3. By definition, the aggregate cost method does not allow for an unfunded actuarial accrued liability (UAAL) to develop. The aggregate normal cost is determined as the level percentage of projected payroll that will fund the difference between the present value of projected benefits and the actuarial value of assets at the valuation date. As a result, any difference between the assets and the projected liability, due to short-term gains or losses, assumption changes or benefit enhancements, is automatically reflected in the

annual cost of the plan and not amortized as a separate component of plan cost. In absence of an effective asset smoothing method, the aggregate cost method can produce volatile contribution rates under certain investment market cycles.

Plan 1, on the other hand, has a separate employer amortization of existing UAAL and the unfunded prior service cost is spread over the projected payroll of the retirement system - including payroll for projected new entrants. This method was selected in deference to the magnitude of the financial obligation to completely amortize the plan 1 UAAL by June 30, 2024. Because the plan 2/3 employer normal cost is used for plan 1 employers, all employers within a retirement system are charged the same contribution rate, regardless of the plan in which their employees hold membership (except for LEOFF). The total employer contribution rate is equal to the plan 2/3 normal cost plus the plan 1 UAAL rate.

The current asset valuation method is intended to address the volatility of contribution rates under the aggregate cost method when used in combination with the existing asset allocation policy. The longer smoothing period employed under the current method for larger annual asset gains or losses will reduce the volatility of future contributions rates once they return to their expected long-term levels.

The current “asset smoothing corridor” provides a direct relationship between the actuarial or smoothed value of assets and the underlying market value of assets. The smoothing corridor ensures that the asset valuation method will produce a reasonable actuarial value of assets, and when used in combination with the actuarial cost method, will produce contributions rates that are dependable and adequate.

Rate Stability - Experience

The current funding policies and methods are all independently reasonable. The end result, however, has produced contribution rates that have not been predictable and have not remained a relatively stable proportion of state budgets. This recent experience is partially explained by significant short-term volatility in the market and actuarial value of assets. Recent changes to the asset valuation method will improve rate stability in the future, but due to the timing of the asset method change, will not prevent significant increases in projected contribution rates. Had the current smoothing method been in place prior to the investment market run-up in the mid to late 1990's, the actuarial

value of assets would have been lower, and the actuarially required contribution rates at the time would have been higher. This would have resulted in the build-up of a temporary “asset reserve” that would have been available to offset the significant asset losses that followed. Given the magnitude of the short-term fluctuations in asset values, however, the new smoothing method would not have prevented the actuarially determined contribution rates from experiencing some degree of volatility.

The primary source of rate instability rests with the systematic use of annual actuarial valuation results under the current funding policy in absence of long-term expectations. The change from discretionary pension funding to systematic actuarial funding in 1989 increased the soundness of the actuarial funding of Washington’s pension systems, but it may have produced a system which overemphasizes short-term results. Under this funding policy, the selection or legislative prescription of certain actuarial assumptions and methods, namely the increase in the interest rate assumption in 2001 from 7.5% to 8% and the former asset valuation method, may have contributed to a shorter-term focus on actuarial results.

Comparative Systems

The following table summarizes the contribution policies for Washington’s comparative systems as reported in the 2001 Survey of State and Local Government Employee Retirement Systems, Public Pension Coordination Council:

Retirement System	Statutory Employer Rate?	Result of Actuarial Valuation?
1. Washington PERS	No	Yes
2. City of Seattle	No*	Yes
3. Oregon	No	Yes
4. Idaho (PERSI)	No	Yes
5. CalPERS	No	Yes
6. CalSTRS	Yes	No
7. Colorado PERA	Yes	No
8. Florida Retirement System (FRS)	No	Yes
9. Iowa (IPERS)	Yes	No
10. Minnesota (General Employees)	Yes	No

11. Missouri (MOSERS)	No	Yes
12. Ohio (OPERS)	No	Yes

** Employer matches the statutorily fixed member contribution plus an “excess contribution” if the actuarially required contribution rate for the plan exceeds the member and matching employer contribution.*

The specific question in the Public Pension Coordination Council survey under contributions was: “How are employer contribution rates established?” Two response options were provided:

- statutorily at a specified rate; or
- result of actuarial valuation.

Most systems responded that employer contributions were established as a result of an actuarial valuation. Four systems, CalSTRS, Colorado PERA, IOWA PERS and the Minnesota Retirement System for general employees, responded that they have statutorily specified employer contribution rates.

Corridor Funding

Several public retirement systems, including the City of Dallas and the Maryland State Retirement system, have modified their funding policies to incorporate what is referred to as “corridor funding.” There are two types of corridor funding:

- normal cost corridor; and
- funded ratio corridor.

Under a normal cost corridor approach, contribution rates are contained within a symmetric corridor, say 90%-110%, of the plan’s normal cost. The normal cost that is expected to provide 100% funding is established as the median point within the corridor.

Under a funded ratio corridor approach, contribution rates are fixed from one period to the next as long as the plan’s funded ratio remains within a specific corridor. For example, in Maryland the current employer contribution rate remains fixed provided the ratio of the plan’s assets to actuarial accrued liability remains between 90% and 110%.

Federal Law

Section 412 of the Internal Revenue Code (IRC) specifies minimum funding rules for qualified private sector plans. An enrolled actuary must certify, on an annual basis, that a private-sector plan sponsor has contributed at least the minimum contribution to their pension plan in order for the plan to receive favorable tax treatment under the IRC. In summary, the minimum contribution is comprised of annual charges and credits under the actuarial cost method for the plan plus an additional funding charge for plans with funded ratios below 80% - based on market or “current liability” interest rates.

Because these rules are based, in part, on market interest rates, which tend to fluctuate from one period to the next, the federal laws governing minimum funding do not provide a good model for contribution rate stability. Government plans are exempt from these minimum funding rules.

Options

Several options were discussed at the SCPP’s May 2004 orientation, including:

- minimum contribution rates;
- maximum rates of change from one period to the next; and
- statutorily fixed contribution rates.

Corridor funding is presented as an option exercised by other public retirement systems.

Analysis of Options

The appropriate option will depend on the plan sponsor’s desire to balance several objectives:

- contribution rate stability;
- contribution rate adequacy; and
- the level of cost sharing between the employee and employer.

Minimum contribution rates that are adjusted upward for the cost of future benefit enhancements, funded equally by both employers and plan 2 employees, will provide adequate rates, maintain the current cost-sharing relationship in the plans 2, but would not be as stable and predictable as rates fixed in statute.

Statutorily fixed rates, on the other hand, may not provide adequate long-term funding of the promised benefits. The current level of employee and employer cost sharing in the plans 2 would be lost and the burden of funding future benefit enhancements or future unfunded liability would fall on the state.

The corridor funding approach would provide for greater rate stability, but likely at the expense of rate adequacy. A normal cost funding corridor would not fund the full actuarially required normal cost each year. A funded ratio corridor approach would also not fund the full actuarially required normal cost each year unless the plan falls outside the funded ratio corridor.

Recommendation of State Actuary

- Establish a minimum plan 2/3 normal cost rate equal to 90% of the normal cost calculated under the entry age normal cost method effective once the aggregate plan 2/3 normal cost rate exceeds the entry age normal cost rate.
 - ▶ The entry age normal cost rate would increase to reflect the cost of future benefit enhancements once effective.
 - ▶ The employer normal cost would equal the plan 2/3 employee normal cost.
- Do not allow the plan 1 UAAL rate, charged to employers only, to decrease until the actuarial value of assets is at least 125% of the actuarial accrued liability.
 - ▶ Would not apply beyond the current amortization date of June 30, 2024.
 - ▶ Would not apply to LEOFF plan 1 unless the plan develops an unfunded actuarial accrued liability in the future.

The entry age normal cost represents the expected long-term annual cost of the plan from a member's entry date - if all assumptions are realized - and does not recognize the impact of any unfunded past liability. The aggregate normal cost is equivalent to the entry age normal cost with short-term gains or losses, at the valuation date, amortized over the expected working lifetime of the current active population. As a result, the aggregate normal cost can drift away from the entry age normal cost depending on the magnitude of short-term actuarial gains and losses. Successive and significant annual actuarial gains will push the aggregate normal cost rate below the entry age normal cost rate; whereas successive and significant annual actuarial losses will push the aggregate normal cost rate above entry age. The substantial investment gains of the mid to late 1990's caused the aggregate normal cost rates to drop well below the entry age rates. A minimum entry age normal cost rate will provide for greater rate stability in the future and, combined with the aggregate normal cost and the new asset smoothing method, will support the objective of contribution rate adequacy and continuing to fully fund the plans 2/3.

The following table compares current and projected employer normal cost (NC) rates under the aggregate method with current average entry age normal cost rates. With the exception of WSP, normal cost rates under the aggregate method are projected to exceed 90% of the average entry age normal cost rate by 2009-11 for all systems listed in the table. This cross-over point is projected to occur at the start of the 2011-13 biennium for WSP.

Employer Normal Cost Rates			
System	Current Aggregate NC*	Average Entry Age NC**	Projected 09-11 Aggregate NC
PERS 2/3	2.63%	4.45%	4.90%
TRS 2/3	1.71%	5.44%	5.01%
SERS 2/3	2.49%	4.72%	5.39%
LEOFF 2	6.41%	8.37%	8.53%
WSP	0.00%	10.51%	8.93%

* From the results of an actuarial valuation performed at 9/30/2002. Contribution rates currently charged to employers are based on the results of an actuarial valuation performed at 9/30/2001 and restated for Chapter 11, Laws of 2003, E1.

** From the results of an actuarial valuation performed at 9/30/2002. Based on current mix of active participants and current plan provisions.

The balance between contribution rate stability and adequacy is a bit more complicated under the plans 1 with unfunded past liabilities. For these closed plans, it may be advisable to err on the side of rate adequacy as opposed to rate stability since these plans are rapidly approaching 100% annuitant or inactive status and are currently in a deficit funding position. The 125% funded ratio trigger should increase the likelihood that once amortized, the plan 1 unfunded actuarial accrued liability will not re-emerge. As an example, contributions to the LEOFF plan 1 UAAL stopped in 2000 when the funded ratio, the value of plan assets divided by actuarial accrued liability, reached 136%. In other words, at that time, LEOFF plan 1 had \$1.36 in actuarial assets for each dollar of accrued liability. As of September 30, 2002, the LEOFF 1 funded ratio had dropped to 119% and is projected to decline for the next several biennia.

The following two tables display projected UAAL rates and projected funded ratios for PERS 1 and TRS 1. The projections are based on actual investment performance through August 31, 2003 and 8% assumed annual investment return thereafter (current long-term actuarial assumption). Short-term investment experience will vary from the long-term actuarial assumption of 8%.

For both PERS and TRS Plans 1, the unfunded actuarial accrued liability (UAAL) is projected to re-emerge following the investment losses of 2000 through 2002. These investment losses largely offset the investment gains of the previous period. As a result, funded ratios for both PERS and TRS plans 1 are projected to decline in the short term, returning to their former levels, and then increase to 100% by the amortization date of June 30, 2024.

PERS - Projected UAAL Rates		
Period	Plan 1 UAAL Rate	Funded Ratio
Current*	0.00%	92%
05-07	1.66%	85%-90%
07-09	2.26%	75%-80%
09-11	2.81%	65%-70%
11-13	3.19%	60%-65%
21-23	3.19%	100%

* Chapter 11, Laws of 2003, E1, suspended payments towards the plan 1 unfunded liability.

TRS - Projected UAAL Rates		
Period	Plan 1 UAAL Rate	Funded Ratio
Current*	0.00%	98%
05-07	1.97%	90%-95%
07-09	3.77%	80%-85%
09-11	5.37%	65%-70%
11-13	6.42%	60%-65%
21-23	6.42%	100%

* Chapter 11, Laws of 2003, E1, suspended payments towards the plan 1 unfunded liability.

A rate ceiling or statutorily fixed rates are not recommended for either the normal cost or the plan 1 UAAL rates since it could impact the adequacy of future contribution rates. For example, it may become necessary to increase contribution rates beyond a ceiling for the cost of future benefit enhancements or if the plan experiences unforeseen actuarial losses in the future.

Summary

Current funding policy outlines the intent to achieve a goal of stable and predictable contribution rates and to continue to fully fund the plans 2/3. Certain actuarial assumptions and methods were selected to achieve these goals. The current funding policies and methods are all independently reasonable. The end result, however, has produced contribution rates that have not been predictable and have not remained a relatively stable proportion of state budgets. This experience is partially explained by recent volatility in the investment markets. The primary source of rate instability rests with the systematic use of annual actuarial valuation results under the current funding policy in absence of long-term expectations.

Several options and recommendations are presented to address the issue of contribution rate stability. The appropriate option will depend on the plan sponsor's desire to balance several objectives:

- ▶ contribution rate stability;
- ▶ contribution rate adequacy; and
- ▶ the level of cost sharing between the employee and employer.

In the case of PERS and TRS plans 1, closed systems with unfunded prior service liability, the objective of contribution rate adequacy may trump the desire for complete rate stability.

Background

Gain-sharing was first implemented for the Plans 1 and 3 in 1998, based on certain assumptions, goals and policies. The Gain-Sharing report was originally dated August 10, 2004 and was revised August 30, 2004. The report examines the assumptions, goals and policies of gain-sharing in light of the impacts and experience of the affected plans over the five-year period since it became effective. It also explores some of the legal, technical and actuarial issues associated with gain-sharing. Finally, the report includes preliminary estimates of the cost of future gain-sharing. The report is intended as an overview as well as a tool for evaluating the gain-sharing provisions in current law.

Committee Activity

Presentations:

August 17, 2004 - Full Committee

Recommendation to Legislature

See specific tabs entitled Plan 1 Gain-Sharing and Plan 3 Gain-Sharing.

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Select Committee on Pension Policy

Gain-Sharing

(August 30, 2004)

Issue

Gain-sharing was first implemented in 1998, based on certain assumptions, goals, and policies. This issue paper examines those assumptions, goals and policies in light of the impacts and experience of gain-sharing over the last five years. This report also explores some of the legal, technical and actuarial issues associated with gain-sharing. The report is intended as an overview as well as a tool for evaluating the gain-sharing provisions in current law.

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Members Impacted

Gain-sharing directly affects retired members of TRS and PERS Plans 1. As of the most recent actuarial valuation (2002), there were 33,148 retirees in TRS 1 and 54,006 retirees in PERS 1. Gain-sharing also affects term-vested, active and retired members of the TRS, SERS and PERS Plans 3. "Term-vested" members are those who left employment, were vested, and who did not withdraw their contributions. As of the most recent actuarial valuation, TRS 3 had 2,151 term-vested members, 45,798 active members and 283 retirees; SERS 3 had 1,148 term-vested members, 26,921 active members, and 185 retirees; and PERS 3 had 198 term-vested members, 15,509 active members and 9 retirees. Plan 2 members do not participate in gain-sharing.

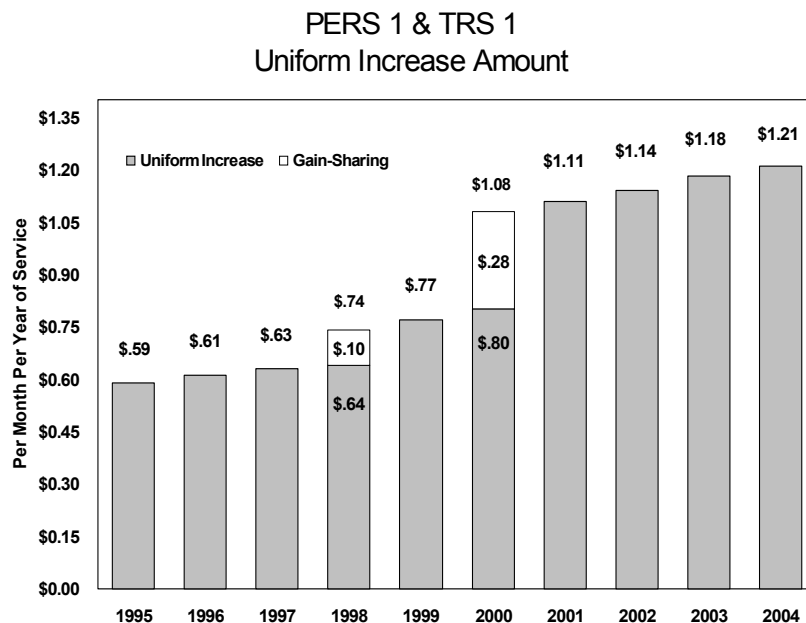
Current Situation

Gain-sharing is a mechanism that increases benefits in PERS 1, TRS 1 and all the Plans 3 (TRS 3, SERS 3 and PERS 3). These increases are not automatic, but are contingent on the occurrence of “extraordinary investment gains.”

Extraordinary investment gains occur when the compound average of investment returns on pension fund assets exceeds 10% for the previous four state fiscal years. The “compound average” recognizes the affect of compound interest. (Compound interest is interest paid on previously earned interest as well as on the principal.)

When the previous four-year compound average investment return exceeds 10%, a calculation is performed to determine a dollar amount that will be distributed to eligible members. Gain-sharing calculations are currently made once each biennium with potential distributions occurring in January of even-numbered years.

Plan 1 gain-sharing is governed by Chapter 41.31 RCW. As implemented for PERS/TRS 1, an amount equal to one-half of the extraordinary investment returns is used to permanently boost the Annual Increase Amount used in calculating the Uniform Cost of Living Adjustment (COLA). The following graph illustrates how gain-sharing distributions have impacted the uniform increase amount.



Plan 3 gain-sharing is governed by Chapter 41.31A RCW. In the Plans 3, active, retired and term-vested members are eligible for gain-sharing distributions. Distributions are made as a lump sum dollar amount that is deposited directly into member's defined contribution account based on years of service credit. The same 10% rate of return is used to determine when extraordinary gains have occurred. A second calculation is then made to determine the dollar amount to be distributed to eligible members. Eligible Plan 3 members' service is divided by all system members' service. This produces the percentage of Plan 2/3 retirement funds which can be attributed to Plan 3 members' service. The Plan 3 percentage is then multiplied by one-half of the dollar amount of extraordinary gains. The Department of Retirement Systems then deposits a fixed dollar amount per year of service to each eligible member.

Example: Plan 3 Gain-sharing Calculation for Year 2000

Gain Sharing Rate	
1995-1996	17.40%
1996-1997	20.50%
1997-1998	16.60%
1998-1999	11.90%
4 Year Average	16.56%
Gain-sharing %	6.56%
Years of Service (YOS) for Eligible Plan 3 Members	286,702.27
Years of Service for Other Members	1,518,868.57
Total YOS	1,805, 570.84
Ratio of Plan 3 to Total (rounded)	15.88%
Total Gain-Sharing Potential	\$458,990,372
Gain-sharing Plan 3	\$72,887,671
Gain-sharing per Plan 3 YOS	\$254.23

History

Legislation

Gain-sharing legislation was first passed in **1998**. At that time, the Washington State Retirement Systems had been experiencing high rates of returns on plan assets. ESHB 2491 (Chapter 340, Laws of 1998) became effective immediately and established gain-sharing for the PERS and TRS Plans 1. The first gain-sharing distribution was scheduled for July 1, 1998.

SSB 6306 (Chapter 341, Laws of 1998) established gain-sharing for the TRS and SERS Plans 3. The TRS 3 provisions took effect immediately and the SERS provisions were to become effective on September 1, 2000 with the creation of SERS. SERS members would receive retroactive gain-sharing on March 1, 2001, based upon service credit accumulated as of August 1997. A second gain-sharing calculation for SERS 3 members was scheduled for March 2001, based upon service credit accumulated as of August 1999.

HB 1023 (Chapter 223, Laws of **1999**) addressed a technical correction to TRS 3 gain-sharing provisions that had passed in the previous legislative session. The 1999 law was designed to allow most TRS 3 members who had transferred from TRS 2 to TRS 3 to receive gain-sharing distributions as intended by the legislature in 1998.

In the year **2000**, ESSB 6530 (Chapter 247, Laws of 2000) created the PERS 3 gain-sharing provisions, which were the same as had been previously provided to TRS 3 and SERS 3. PERS Plan 3 was to become effective on March 1, 2002. The first gain-sharing payment was to be made March 1, 2003, and would be equal to the gain-sharing payments made to TRS Plan 3 members in January 2000.

2003 legislation affecting gain-sharing provisions involved only certain technical corrections involving statutory cross-references. Other non-SCPP bills have been introduced to: increase the frequency of gain-sharing distributions; change the definition of “extraordinary gains” by lowering the interest rate threshold from 10% to 8%; provide for lump sum payments in lieu of Plan 1 COLA increases; distribute gain-sharing to retirees based upon a point system (1 point for each year of service credit and 2 points for each year of retirement); and apply gain-sharing to members of LEOFF Plan 2. None of the non-SCPP bills concerning gain-sharing have passed.

Historical gain-sharing

The following table summarizes past gain-sharing distributions to members of the Plans 1 and 3:

Historical Gain-sharing (Dollars in Millions)				
Distribution Date	PERS1/TRS 1	TRS 3*	SERS 3**	PERS 3***
7/1/1998	\$290	\$28		
1/1/2000	\$634	\$73	\$50	\$26

* TRS 3 members received both 1998 and 2000 gain-sharing distributions. Payments were not retroactive.

**SERS 3 members received both 1998 and 2000 gain-sharing distributions. Payments were retroactive. The total for both distributions is reflected in the 1/1/2000 row.

***PERS 3 members received gain-sharing for 2000 only. Payments were retroactive.

The total dollars spent for benefit improvements in the past two gain-sharing distributions was roughly \$1.1 billion. These distributions do not include dollars allocated to shorten the amortization period for the Plans 1. Those dollars amounted to another \$290 million in 1998 and \$634 million in 2000 for a grand total of roughly \$2 billion. In 2001, however, the Plan 1 payoff date was extended back out to 2024, the same as it was prior to gain-sharing. The benefit enhancements and the adjustments to the Plan 1 amortization period are described in more detail below.

Policy Analysis

The original gain-sharing mechanism was developed within a framework of Joint Committee on Pension Policy goals. The goals for gain-sharing included:

1. An on-going process that is understandable, stable, and would take place with meaningful frequency.
2. No additional unfunded long-term liabilities.
3. Immediate benefit improvements funded by recent investment gains.
4. Future benefit improvements whenever the assets invested in the retirement trust accounts experience extraordinary gains.
5. An acceleration of the date for paying off the unfunded actuarial liability of PERS 1 and TRS 1.

It was also expected that funding benefit improvements when there are extraordinary investment returns gains would decrease the effect of those returns on employer contribution rates. In other words, it was expected that employer contribution rates would not flatten or be driven downward if the gains triggered benefit improvements and reductions of the Plan 1 unfunded liabilities. See Gain Sharing, Report to the Joint Committee on Pension Policy, January 13, 1998. This approach seemed to assume that future employer rates would be set in response to market forces. They would go down when markets are good, and back up when markets are bad. While legislatures may choose to set contribution rates on an ad hoc basis, there are other ways to address contribution rate-setting. See Contribution Rate Setting, July 2, 2004 Report to the SCPP by the State Actuary.

This policy analysis will compare these goals to the experience of the last five years. This section of the report will also explore some of the technical/legal and actuarial constraints that affect gain-sharing.

Goal 1: An ongoing process that is understandable, stable, and would take place with meaningful frequency.

Gain-sharing is ongoing in the sense that it is a benefit enhancement that has been built into the affected plans through the mechanism of pension plan amendments. These plan amendments require that gain-sharing distributions be made in the future whenever certain specified conditions are met. The gain-sharing provisions are, however, subject to a “no contractual right” clause. This clause states that “no member or beneficiary has a contractual right to receive this distribution not granted prior to that time.” These kinds of clauses have not been tested in the Washington courts. This legal uncertainty lends an aspect of unpredictability to the gain-sharing benefit.

Gain-sharing distributions have been triggered in two instances in the last five years. The first distribution occurred on July 1, 1998. Thereafter, gain-sharing distributions were to occur on January 1st of even-numbered years, assuming that the affected plans experienced extraordinary investment returns. The second distribution was triggered for January 1, 2000. On January 1 of 2002 and 2004, there were no extraordinary investment returns available to trigger a gain-sharing distribution.

The frequency of gain-sharing in the future is tied to annual investment returns, which are unpredictable. When gain-sharing legislation was passed in 1998, it was estimated that the 10% threshold for distribution of extraordinary gains would have been exceeded in 21 of the past 34 biennia. However, the past is not necessarily a predictor of the future. While the trigger mechanism for gain-sharing is fixed, the incidence of future gain-sharing is unknown.

In summary, the frequency of future gain-sharing is:

- subject to legal uncertainty;
- unpredictable due to market fluctuations.

Goal 2: No additional unfunded long-term liabilities.

At its inception, gain-sharing was almost viewed as a “no cost” item, i.e. it would only occur when times were good, and it would simply keep employer contribution rates from going down during those good times. In addition, the law has not allowed for any adjustment to the **supplemental** contribution rate for gain-sharing. See RCW 41.45.070(7). The supplemental rate is a temporary contribution rate increase that is made to reflect the cost of benefit changes until those changes can be included in the next actuarial valuation.

The future cost of the gain-sharing benefit provisions of PERS and TRS Plans 1, and PERS, TRS and SERS Plans 3 was not reflected in the 2002 actuarial valuation. However, the actuarial certification in the 2002 Actuarial Valuation Report noted that the funding methodology and materiality of the gain-sharing provisions were under review. Such review is required by the Actuarial Standards of Practice promulgated by the American Academy of Actuaries. (See Standards 4 and 27.) These standards require that material liabilities of the plan be identified so they can be “pre-funded.” The State Actuary is now identifying gain-sharing as a material liability due to the future cost associated with this benefit, and this liability will be reflected in the 2003 Actuarial Valuation.

Estimated Fiscal Impact of Future Gain-Sharing

Future gain-sharing will impact the actuarial funding of the systems by increasing the present value of benefits payable under the systems and the required actuarial contribution rates as shown below:

<i>(Dollars in Millions)</i>		Current	Increase	Total
Actuarial Present Value of Projected Benefits (The Value of the Total Commitment to all Current Members)	PERS 1	\$12,715	\$504	\$13,219
	PERS 2/3	14,159	119	14,278
	TRS 1	10,341	426	10,767
	TRS 2/3	4,876	344	5,220
	SERS 2/3	1,979	159	2,138
Unfunded Actuarial Accrued Liability (The Portion of the Plan 1 Liability that is Amortized at 2024)	PERS 1	\$2,123	\$497	\$2,620
	TRS 1	1,012	404	1,416
Increase in Contribution Rates: (Effective 2005)		PERS	SERS	TRS
Employee		0.00%	0.00%	0.00%
Employer State		0.65%	2.35%	2.01%

Fiscal Budget Determinations

As a result of the higher required contribution rates, the increase in funding expenditures is projected to be:

<i>(Dollars in Millions)</i>	PERS	SERS	TRS	Total
2005-2007				
State:				
General Fund	\$19.8	\$31.7	\$122.7	\$174.2
Non-General Fund	<u>32.6</u>	<u>0.0</u>	<u>0.0</u>	<u>32.6</u>
Total State	\$52.4	\$31.7	\$122.7	\$206.8
Local Government	46.6	28.0	25.2	99.8
Total Employer	99.0	59.7	147.9	306.6
Total Employee	\$0.0	\$0.0	\$0.0	\$0.0
2007-2009				
State:				
General Fund	\$24.1	\$41.1	\$150.9	\$216.1
Non-General Fund	<u>39.9</u>	<u>0.0</u>	<u>0.0</u>	<u>39.9</u>
Total State	\$64.0	\$41.1	\$150.9	\$256.0
Local Government	56.7	36.4	30.9	124.0
Total Employer	120.7	77.5	181.8	380.0

<i>(Dollars in Millions)</i>	PERS	SERS	TRS	Total
Total Employee	\$0.0	\$0.0	\$0.0	\$0.0

<i>(Dollars in Millions)</i>	PERS	SERS	TRS	Total
2005-2030				
State:				
General Fund	\$426.5	\$912.6	\$2,857.2	\$4,196.3
Non-General Fund	<u>703.5</u>	<u>0.0</u>	<u>0.0</u>	<u>703.5</u>
Total State	\$1,130.0	\$912.6	\$2,857.2	\$4,899.8
Local Government	1,002.5	808.8	585.0	2,396.3
Total Employer	2,132.5	1,721.4	3,442.2	7,296.1
Total Employee	\$0.0	\$0.0	\$0.0	\$0.0

The costs presented in this estimate are based on our understanding of existing gain-sharing provisions as well as generally accepted actuarial standards of practice including the following:

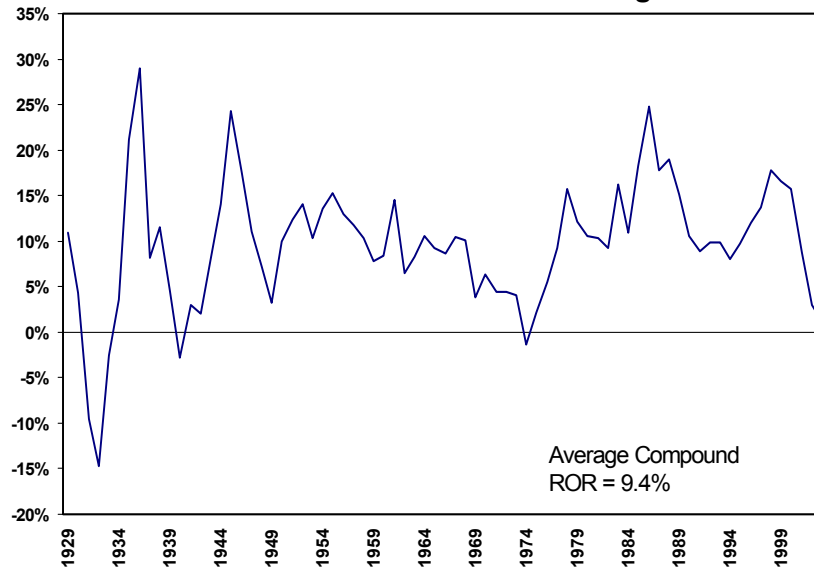
1. *Costs were developed using the same membership data, methods, assets and assumptions as those used in preparing the September 30, 2003 draft actuarial valuation report of the Retirement Systems.*
2. *As with the costs developed in the actuarial valuation, the emerging costs of the systems will vary from those presented in the valuation report or any fiscal note to the extent that actual experience differs from that projected by the actuarial assumptions.*
3. *The funding method used for Plan 1 utilizes the Plan 2/3 employer/state rate as the Normal Cost and amortizes the remaining liability (UAAL) by the year 2024. Benefit increases to Plan 2/3 will change the UAAL in Plan 1. The cost of benefit increases to Plan 1 increases the UAAL.*
4. *Plan 2/3 utilizes the Aggregate Funding Method. The cost of Plan 2/3 is spread over the average working lifetime of the current active Plan 2/3 members.*
5. *The employee/employer level of cost-sharing as defined in the actuarial funding chapter - Chapter 41.45 RCW - provides that the cost of Plan 3 benefit enhancements is shared equally among Plan 2/3 employers and Plan 2 employees.*

Under current law, extraordinary gains are determined every other year, and an amount equal to one-half of the extraordinary gains is distributed for benefit improvements. However, proposals have been made to increase the amount and frequency of gain-sharing. The estimated cost of reserving all of the extraordinary gains for benefit improvements can be illustrated by the following charts, which show the effects on investment returns. The first graph shows the 4-year average compound rate of return (ROR) using today's retirement plan asset mix as spread over the 1929 to 2003 period, which yields a 9.4% rate of return. (Currently, the assumed actuarial rate of return is 8%.)^{*} The second graph shows the 4-year average compound rate of return using the same asset mix over the same period, but with all of the extraordinary gains being allocated to benefit improvements. The full appropriation of extraordinary gains lowers the rate of return from approximately 9.4% to 7.2%.^{**}

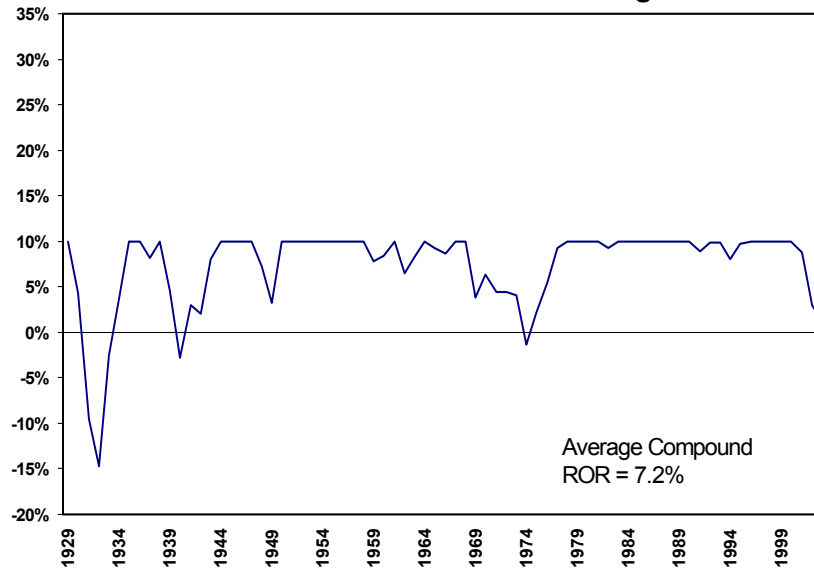
^{*}The graphs on page 10 are for illustrative purposes only. It is not appropriate to use them for setting the assumed investment rate of return for purposes of the actuarial valuation. For additional information on setting the assumed investment rate of return, see letter from the State Actuary to the Pension Funding Council dated May 25, 2004.

^{**} The graphs on page 10 are for illustrative purposes only and were not used to develop the estimated fiscal impacts of future gain-sharing.

**Investment Rate of Return by Current
Asset Mix: 1929 - 2003 4-Year Averages**



**Investment Rate of Return by Current
Asset Mix: 1929 - 2003 4-Year Averages**



The second graph illustrates the scenario in which the “peaks” of investment returns (i.e. those in excess of 10%) have been “skimmed.” The average compound rate of return is lowered because the peaks are no longer available to offset the “valleys” or low periods of investment returns. The valleys remain the same, while the peaks are “lopped off.” This pattern could change depending on the asset allocation policy of the Washington State Investment Board. For example, if allocations to certain high-volatility asset classes such as public and private equity were reduced in the portfolio, there could be fewer instances of “extraordinary gains.”

An original goal of gain-sharing was “no additional unfunded liabilities.” However due to the fact that future gain-sharing distributions have not been pre-funded, gain-sharing has significantly increased the unfunded long-term liabilities of the affected plans.

Goal 3: Immediate benefit improvements funded by recent investment gains.

The gain-sharing legislation for the Plans 1 became effective immediately and thus resulted in immediate benefit improvements. The first gain-sharing distribution in 1998 provided a \$.10 increase in the Annual Increase Amount used to calculate the Uniform COLA. The Uniform COLA provides a cost-of-living adjustment to Plan 1 retirees beginning at age 66 based on the retiree’s service credit. The Uniform COLA began in 1995 at \$.59 per month per year of service credit and increases 3% annually. When gain-sharing was passed in 1998, the Uniform COLA was at \$.63 per month per year of service. The \$.10 increase was permanent and is part of the base for determining the regular annual increases.

The 1998 gain-sharing distribution also paid the actuarial present value (using a one-time payment) of a retroactive “pop-up” benefit for retirees who retired prior to 1996 and elected a survivor benefit. The “pop-up” provided that if the retiree is predeceased by the beneficiary, the retiree’s benefit is restored to its unreduced level at the beginning of the month following the death of the beneficiary. Those retirees who had already been predeceased by their beneficiaries had their benefits restored on the effective date of the act (July 1, 1998). The one-time cost of providing this benefit was \$52 million.

The 1998 gain-sharing distribution to Plan 3 members was \$134.43 per year of service credit. The gain-sharing amounts were distributed as lump sums deposited into Plan 3 members' defined contribution accounts.

Were these benefit improvements "funded by" recent investment gains? As explained when gain-sharing was first proposed, there are two primary methods for funding benefit improvements: a contribution rate increase, or a present-value payment. A contribution rate increase pays off the cost of the new benefit over time. A present-value payment is a one-time payment into the retirement system to cover all the estimated future costs of the benefit.

Past gain-sharing distributions resulted in transfers from the retirement trust accounts to individual members. Significant dollars were paid out of the retirement system. Past gain-sharing benefits were paid for in the sense that employer contribution rates stayed at a higher level than they would have absent gain-sharing. However no mechanism was established to pay for future gain-sharing. Many have assumed that the "extraordinary gains" somehow pay for the benefits. However "extraordinary gains" are simply the market events that triggered the timing of benefit improvements. Their long-term cost must be funded by either higher contribution rates or appropriations of new money into the retirement system.

In thinking about the fact that gain-sharing itself is not a funding mechanism for future benefit improvements, it may be useful to compare extraordinary investment gains with actuarial gains. Actuarial gains are generated by favorable plan experience. In other words, when a retirement plan is funded based on certain assumptions (including the assumed rate of investment return and various demographic assumptions) that are too conservative, it is more likely that the long-term plan experience will be more favorable than the assumptions. Favorable plan experience generates actuarial gains.

When assumptions are not conservative enough, there is less opportunity for favorable plan experience. Without favorable plan experience, there are no gains and there may even be increases in liability. Generally, actuarial assumptions are periodically adjusted to be as consistent as possible with plan experience. Thus, overall, actuarial gains are used to offset actuarial losses, just as investment gains offset investment losses.

When benefit enhancements are funded indirectly through temporary gains and not directly through increased contribution rates or one-time pay-outs, then those gains are no longer available in the future to offset losses. In effect, it is as if the gains have been capped. The approach leads to increased future liabilities. This is not to say that retirement plans never have surpluses which can be used for reasonable benefits enhancements. However, an asset surplus is not the same as a prolonged stock market surge. An asset surplus occurs when all liabilities have been satisfied and there is still money left over. This is not the case in the Plans 1 or the Plans 3; thus benefit improvements still require a funding mechanism that is related to their cost.

In summary, in accordance with its original goals, gain-sharing generated significant immediate benefit improvements upon passage of the initial legislation. Those enhancements, however, were not funded by recent investment gains; rather, the benefit improvements were funded by employer contributions. Similarly, future benefit enhancements that are triggered by gain-sharing events will require additional funding in order to avoid future increases in plan liabilities.

Goal 4: Future benefit improvements whenever the assets invested in the retirement trust accounts experience extraordinary gains.

Looking at the future from the perspective of the Joint Committee on Pension Policy in 1998, we see that the 2000 gain-sharing distribution was much larger than the 1998 distribution. It provided a second permanent increase in the Uniform COLA amount for TRS 1 and PERS 1 of \$.28 as of January 1, 2000. Eligible members of the Plans 3 received \$254.23 per year of service credit as lump sums deposited into their defined contribution. There were no gain-sharing distributions in 2002 or 2004.

As mentioned before, while the trigger mechanism for gain-sharing is fixed, the incidence of future gain-sharing is unknown. Also, as explained earlier, while gain-sharing provisions trigger certain future benefit payments according to a pre-determined formula that varies with the size of the investment gains, there is no official funding mechanism provided to pay for the resulting benefit improvements that will occur. It is simply assumed that a) gain-sharing will only occur when contribution rates are otherwise decreasing, and b) the distributions will result in employer contribution rates remaining at a higher level than they would have been absent gain-sharing.

Goal 5: An acceleration of the date for paying off the unfunded actuarial liability of PERS Plan 1 and TRS Plan 1.

Accelerating the date for paying off the unfunded actuarial accrued liability (UAAL) has an effect on contribution rates. When the amortization period for plan liabilities is shortened, contribution rates must be higher. When the amortization period is lengthened, contribution rates can be lower. This is similar to a mortgage payment, in that a shorter mortgage period means a higher monthly payment and a longer mortgage period means a lower monthly payment. In PERS 1 and TRS 1, member contribution rates are fixed by statute at 6% of pay. Thus, when contribution rates fluctuate due to a change in the amortization period, it is the employer contribution rate that is adjusted.

The original gain-sharing legislation provided that an amount equal to one-half of the extraordinary investment gains would be used to shorten the amortization period for unfunded liabilities in PERS 1 and TRS 1. This provision of the original gain-sharing legislation was codified in RCW 41.45.060(5). In 1998, the unfunded liability amortization period was rolled back from 2024 to 2022. In 2000, the amortization period was rolled back from 2022 to December 31, 2016. Then in 2001, the provision requiring that gain-sharing distributions be used to pay off the unfunded liability of the Plans 1 dropped out of the law. The amortization period for PERS and TRS Plan 1 unfunded liability was extended back out to 2024.

Currently there is no legal requirement that gain-sharing distributions be used to reduce the unfunded liability of PERS 1 or TRS 1. Furthermore, the scheduled payoff date of June 30, 2024 for Plan 1 liabilities is now the same as it was before gain-sharing.

Policy Constraints

Funding policies in the Actuarial Funding Chapter

The following general funding policies have been adopted for the Washington State Retirement Systems, and are codified in RCW 41.45.010:

1. to continue to fully fund the Plans 2 and 3;
2. to fully amortize the total costs of the Plans 1 by 2024;

3. to establish predictable long-term employer contribution rates which will remain a relatively constant proportion of future state budgets; and
4. to fund benefit increases over the working lives of members so the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service.

Gain-sharing was originally passed to be funded on a pay-as-you-go basis. It was expected that employer contribution rates would simply be kept higher during those times when they would otherwise be going down in response to favorable market returns. Also, the pay-as-you go approach was favored because of difficulties in projecting future gain-sharing events and their attendant liabilities.

Because future gain-sharing benefits have not been pre-funded, gain-sharing may be viewed as inconsistent with the above funding policies. With respect to policy #1, gain-sharing has a significant cost that is not reflected in current employer contribution rates. To that extent it may be said that the Plans 3 are not fully funded. Policy #2 calls for the unfunded liabilities of the Plans 1 to be paid off by 2024. To the extent that gain-sharing provides for permanent future benefit increases that have not been pre-funded, there is the possibility that future gain-sharing would create additional unfunded liability, thereby extending the pay-off date. With respect to policy #3, we know that future gain-sharing events will occur irregularly during the future due to market volatility. If gain-sharing benefits are not pre-funded, then employer contribution rates will be adjusted to accommodate gain-sharing benefits only in response to market fluctuations. It may be said that this type of funding is not predictable or systematic. Finally, due to the unpredictability of gain-sharing events, some generations of taxpayers may be benefitted by gain-sharing distributions more than others, while some may be burdened more than others. If so, the gain-sharing program would be inconsistent with policy #4.

Parity among plans

RCW 41.50.005(1) sets forth as retirement policy that the retirement systems of the state shall provide similar benefits whenever possible. The application of gain-sharing to members is currently very different for the Plans 1, the Plans 2 and the Plans 3 of the Washington State Retirement systems. When gain-sharing distributions are triggered, members of PERS 1 and TRS 1 receive permanent increases through the Uniform COLA, while Plan 3 members receive

lump sum distributions into their defined contribution accounts. Plan 2 members to not participate directly in gain-sharing. Theoretically, they participate indirectly by having their contribution rates adjusted (along with that of their employers).

In the Plans 1, members have no control over their contribution rate, which is statutorily set at 6%. In the Plans 3, which are hybrid plans, members decide (from six options) how much they will contribute to the defined contribution portion of their plan. (The Plan 3 defined benefit is employer-provided.) In the Plans 2, member contribution rates change to reflect the cost of the plan.

Theoretically Plan 2 members, like employers, can enjoy lower contribution rates when economic times are good. However, since Plan 2 member contribution rates change to reflect the cost of the plan, their contribution rates are also subject to increase when economic times are bad. In other words, Plan 2 members are sharing in both gains and losses, which offset each other over time under a reasonable set of actuarial assumptions. This is in direct contrast to gain-sharing for members of the Plans 1 and 3, who receive permanent benefit improvements without participating in the offsetting losses.

Federal Law Constraints

Final regulations were effective June 15, 2004 concerning required minimum distributions under Internal Revenue Code Section 401(a)(9). Under these rules, tax benefits that were given during a participant's working years are recaptured from pay-outs during the retirement years. Generally, the rules limit the ability to avoid taxes by "back loading" annuities to pay less in the early years of retirement. In particular, the regulations permit increases in payments solely to reflect better-than-assumed investment performance, e.g. gain-sharing. However, there are specific requirements related to the measurement of actuarial gains from investment experience. These requirements should be reviewed with tax counsel to assure on-going compliance with Section 401(a)(9).

Private Sector Models

In the private sector, many companies provide what is known as "profit sharing." With profit sharing, a company establishes a target profit level. If actual profits exceed the target, then a percentage of the excess is divided

among employees. There are several types of profit sharing plans: current distribution (cash) plans, deferred payout plans and combination plans. Under current distribution plans, a profit sharing bonus is paid in cash or in shares. Under deferred payout plans, the profit sharing amount is placed in trust for later payment at termination or retirement. There are also combination or hybrid profit sharing plans that use elements of both current distribution elements and deferred payout elements.

Another form of profit- or gain-sharing is to grant bonuses to employees who generate ideas or take actions that result in cost-savings for their employer. These programs have been used more in the private sector, but have also been used in the public sector to promote government efficiency, for example in Baltimore County, North Carolina and Washington.

Gain-sharing is relatively new in the public sector. According to a nationwide survey by Fox, Lawson & Associates, fewer than 6% of public sector organizations in the United States, from school districts up through state-level organizations, had implemented a gain-sharing program in 1997. This may be explained, in part, by the fact that governmental retirement systems are not funded to generate profits. Public retirement systems are typically funded so that the liabilities of member benefits are completely funded over the working lifetime of the members. If there is a surplus then taxpayers and members have paid too much. If there is unfunded liability that is too large to be amortized over the working lifetime of the members, then taxpayers and members have paid too little. Actuaries assist employers in setting contribution rates that are adequate to address the long-term liabilities of the system.

Cost-sharing

If gain-sharing is not really about sharing in “gains” or “profits,” then why do we have gain-sharing? In the context of the Washington State Retirement Systems, gain-sharing is more about cost-sharing than profit sharing. When employer contribution rates are coming down, members with fixed contribution rates may receive benefit improvements in order to share in the reduced costs. Since such members are unable to experience reduced contribution rates based on variations in the market, they can receive benefits improvements of equivalent value.

Conversely, however, when employer contribution rates are going up, Plan 1 and Plan 3 members do not share in the increased costs (or experience plan “losses”) for two reasons: first, their contribution rates are fixed, and secondly, as a general matter, permanent benefit increases cannot be subsequently reduced. Therefore, in the Plans 1 and 3, the employer covers all “losses” or increased costs. The contribution rates of Plan 2 members, on the other hand, are subject to increases to cover increased liabilities. Plan 2 members share in both reduced costs and increased costs.

Comparison with Other Retirement Systems

A review of the websites and handbooks for Washington’s ten comparative retirement systems revealed three states that have adopted gain-sharing provisions: Colorado, Idaho and Minnesota. In addition, the Retirement Committee for the California Teachers’ Association State Council had “gain-sharing ad hoc benefit for retirees” on its list of legislative priorities in 2000 and 2001, but it dropped off the list in 2002. Other systems outside Washington’s comparative systems that have enacted gain-sharing (or similar) provisions include Arizona, Louisiana and New York City. The approaches of these systems differ considerably. The following discussion summarizes the gain-sharing experience in several jurisdictions.

Arizona

Arizona passed legislation creating a “Permanent Benefit Increase (PBI) COLA for retirees of the Arizona State Retirement System. Under the PBI, a portion of the investment returns, as measured on the actuarial value of assets, that exceeds 8% is “used” for retiree COLAs. If the retiree liability is one-third of the total liability, then one-third of the excess is “available” for the PBI. The retiree COLA’s are paid whenever there is enough “set aside” to fund them. An enhanced PBI COLA is paid to those who retired with a minimum of ten years of service credit and have been retired for five or more years. The intent of the enhanced PBI is to help offset the cumulative effects of inflation since retirement.

The retirement system built up a large reserve in the late 1990's and has been paying 4% COLAs to most retirees since then. However more recently, due to poor investment returns, it is estimated that the reserve will be depleted within the next couple of years. At that point, no COLAs will be given until actuarial

returns exceed 8% again. The cost of these benefit increases (COLAs) is added to the existing liabilities of the retirement system. There is no direct recognition of the PBI feature in the actuarial assumptions.

Colorado

Gain-sharing for members of Colorado's Public Employees' Retirement Association (PERA) was designed to allow employees and retirees to share benefits when the retirement plan is over-funded. 50% of over-funding went to active members in the form of a match to contributions to the 401(k) optional plan or to some other employer-sponsored tax-sheltered vehicle. The "Matchmaker" program for active members involved a dollar-for-dollar match of up to 1% of pay. Gain-sharing was also distributed to retirees as a contribution to the health care trust fund where it could be used to finance increases in a health care subsidy provided to retirees. Matchmaker was suspended by the legislature this year. The Colorado legislature also reduced contributions to the health care trust this year by .08%. Coincidentally, the legislature has adopted a plan to gradually increase employer contributions from 9.9% to 12.9% in 2012.

Idaho

The Public Employee Retirement System of Idaho (PERSI) adopted a gain-sharing program in 2000. As part of the program, PERSI established the Choice Plan, a defined contribution (DC) plan for active members. Gain-sharing distributions to active members would be deposited into their DC accounts and retirees would receive a 13th check. PERSI paid a gain-sharing distribution of \$155 million to members, retirees and employers in 2001. State employers, however, were directed to return 80% of gain-sharing to the state's general fund; 20% was to be used for training. Other employers used gain-sharing as they saw fit.

Today Idaho is in the process of increasing contribution rates. The increases are being phased in over a three- year period ending in 2006. These increases will bring contribution rates back to their 1997 levels.

Louisiana

Louisiana established an “experience account” to be credited with 50% of the retirement system’s net investment experience gain and debited for 50% of the system’s net investment losses for each year. The retirement board was required to grant cost-of-living adjustments (COLAs) when the experience balance was sufficient to fund the COLA in full.

The State of Louisiana’s Legislative Actuary recommended that the experience account be viewed merely as a temporary holding account, emphasizing that “**it does not fund** COLA benefits.” That is because the earnings held in the account are needed to meet the actuarial assumed long-term average return. He asserted that the experience account was just a measuring device that the state could use to grant COLAs.

As explained by Louisiana’s actuary, COLAs create an additional benefit liability that increases the unfunded accrued liability. He also pointed out that the key to ultimately achieving the expected return is that all investment income is credited to the asset base from which it is derived. If income is diverted for other purposes the assumed rate will not be achieved. This in turn destroys the required match between future benefit payments and assets available to pay for them. For that reason, the Actuary recommended that additional contributions be made to restore the funding balance between future assets and liabilities, and that contribution rates be independent of the experience account’s “interference.” See State of Louisiana Legislative Audit, July 2002. The estimated cost of “pre-funding” the Louisiana COLAs was approximately \$2.2 billion for teachers and state employees.

Minnesota

The Minnesota State Retirement System (MSRS) currently provides two types of post-retirement adjustments: 1) a cost-of-living adjustment and 2) an investment performance component. Minnesota’s gain-sharing is triggered when investment gains averaged over a five-year period exceed a specified amount - that is, the amount to cover the cost-of-living adjustment increase and the 6% return required to pay for the base benefit. This means that the cost-of-living component is pre-funded but the investment component is not.

According to the MSRS Handbook, the Minnesota's gain-sharing mechanism resulted, on average, in about a 7% increase in monthly benefits each year over the last 12 years. Now Minnesota reports problems since markets have fallen. It is expected that future post-retirement increases from the investment component will be substantially lower than those paid over the last few years. The increases for the next several years are projected to likely match inflation, up to 2.5%. Minnesota's Member Handbook states: "Unless the stock market rebounds dramatically, there will not be an investment component [to provide for increases after retirement]."

New York City

The New York City Employees' Retirement System (NYCERS) experimented with a gain-sharing mechanism referred to as "skimming" in order to improve retirement benefits for corrections officers. The benefit was to be funded with a portion of the earnings generated through NYCERS' equity investments. Excess earnings would be "skimmed" and put into a separate fund. The assets and earnings of this separate fund would be used to pay for the additional retirement benefits. In effect, excess earnings were moved from one "pot" to another, effecting a "cap" on earnings. As discussed earlier in this paper, a cap on earnings increases the need for higher contributions in the future.

When skimming was first proposed, there was some debate about the fiscal impact of skimming. The city's chief actuary estimated that the plan could cost \$68-130 million annually in increased pension contributions using a net present value approach that discounted all future added benefits plus foregone investment income to its present value. The City Council estimated a cost of \$6 million in 2000 rising to \$75 million by 2009, and continuing to increase thereafter, using a "pay-as-you-go" approach that reflected the costs of the skim as they would occur on a year to year basis. That is, the city's contribution would not reflect any of the cost of expected future payments or NYCERS earnings foregone as a result of those payments.

Skimming passed, but was later repealed and replaced with a benefit of equivalent value.

Conclusion

Gain-sharing is a mechanism for triggering benefit enhancements. It is not a funding mechanism. The benefits that are distributed when there is a gain-sharing event are part of the liabilities of the affected pension plans and must be paid for just like any other benefit enhancement. Gain-sharing was initiated in response to the favorable market conditions of the late 1990's. Since the extraordinary gains of that period were spent for benefit enhancements, those gains were not available to offset the market losses that followed. Thus future contribution rate increases must respond not only to recent market losses, but also to the ongoing liabilities for benefit enhancements associated with gain-sharing events.

Gain-sharing experience over last five years has not been consistent with its original goals, nor is it consistent with the current policies codified in the actuarial funding chapter. The gain-sharing program is founded on a “pay-as-you-go” philosophy, while long-term funding objectives for the retirement systems at large utilize systematic actuarial pre-funding.

Background

Among the suggested issues for the Select Committee on Pension Policy (SCPP) to hear in the 2004 interim were those dealing with the Law Enforcement Officers' and Fire Fighters' plan 1 (LEOFF 1). These issues range from funding and contribution rates, survivor benefits, contributions to medical accounts, disability board membership, and the 60% benefit cap. Recent legislative proposals have sought to address most of these issues. This report provides background information on the LEOFF 1 plan, and briefly discusses the fiscal and policy impact of each of these issues.

Committee Activity

Presentation:

October 19, 2004 - Full Committee

Recommendation to Legislature

See specific issue tabs.

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Select Committee on Pension Policy

LEOFF 1 Issues – Summary

(December 21, 2004)

Issue	Description	Fiscal Impact
Liability	Actuarial present value of fully projected benefits	\$4,338 million
	Based on actuarial value of assets.	\$757 million
Surplus (Deficit) at 9/30/02*	Based on market value of assets.	\$(278) million
	Amount required to keep the plan in full funding based on current actuarial assumptions and benefits.	\$278 million
Survivor Benefits¹	HB 3173: Allow the spouse from a post-retirement marriage to receive fractional survivor benefits (actuarially adjusted) even with the presence of a qualified ex-spouse.	\$0
Contributions to Medical Accounts¹	HB 3174: Establish medical accounts using contribution rate savings of employers and members to help employers pay for catastrophic illnesses of members or beneficiaries.	\$0 impact on LEOFF 1, \$8 million impact on employers and members
Disability Board Membership	HB 3114 / SB 6355: Clarify the qualifications of the members eligible to vote and serve on disability boards – must be active or retired from an entity subject to the jurisdiction of the board. If no fire fighters or police officers are eligible to vote, remaining eligible LEOFF 1 members will elect a second board member.	\$0
60% Benefit Cap	HB 2914: Remove the 60% benefit cap in LEOFF 1.	\$19 million reduction in surplus
70% Benefit Cap	HB 2416: Raise the 60% benefit cap in LEOFF 1 to 70%.	\$16 million reduction in surplus
End Contribution Holiday	Begin employer and member contributions before the plan emerges from fully funded status (7/1/05).	\$13 million increase in surplus
Residual Surplus (Deficit)²	Amount of surplus (deficit) after enactment of legislative proposals.	\$(284) million

* *Future forecasts, which will recognize more recent market performance, may show different results.*

¹ *Also may have an administrative impact on the Department.*

² *Based on the removal of the 60% benefit cap and resumption of contributions.*

Select Committee on Pension Policy

LEOFF 1 Issues

(October 18, 2004)

Issues

Among the suggested issues for the Select Committee on Pension Policy (SCPP) to hear in the 2004 interim were those dealing with the Law Enforcement Officers' and Fire Fighters' plan 1 (LEOFF 1). These issues range from funding and contribution rates, survivor benefits, contributions to medical accounts, disability board membership, and the 60% benefit cap. Recent legislative proposals have sought to address most of these issues. This report will provide background information on the LEOFF 1 plan, and briefly discuss the fiscal and policy impact of each of these issues.

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Members Impacted

The LEOFF 1 plan has, as of the most recent valuation, 991 active members and 8,054 retirees.

Current Situation

The LEOFF plan was created at the request of numerous municipalities and local governments in Washington whose public safety related retirement plans had become too costly. Throughout the post-war era, smaller municipalities attempted to keep up with the more generous large-city retirement plans. In doing so, they became less able to pay for the ever increasing benefits. The State agreed to establish a consolidated plan that would require

retirement contributions from employees, employers, and the State. Among the stipulations agreed to in this plan consolidation was that no member's prior act benefits would be negatively impacted.

The LEOFF 1 plan was created on March 1, 1970 (Chapter 209 Laws of 1969), and closed on September 30, 1977 with the creation of LEOFF 2. Statutes governing the LEOFF 1 plan are found in Chapter 41.26 RCW. A comprehensive description of LEOFF 1 plan provisions can be found in Appendix A.

Retirement Benefit: LEOFF 1 is a defined benefit plan covering full-time fully compensated law enforcement officers and fire fighters. Eligibility for membership generally required meeting minimum medical, health, and age standards. It provides a retirement benefit equal to 2% of a member's final average salary, or FAS (the basic salary attached to the position or rank at retirement if held for at least 12 months) times their years of service, to a maximum of 30 years. Members are eligible to retire after 5 years of service and attainment of age 50.

Disability Benefit: A LEOFF 1 member who becomes disabled, as determined by their local disability board, is eligible to receive a benefit equal to 50% of FAS with an additional 5% of FAS for each dependent child to a maximum of 60% of FAS. LEOFF 1 members do not pay into the State Worker's Compensation program and thus are not eligible for those disability benefits.

Survivor Benefit: Survivor benefits for active members are equal to 50% of the member's FAS at time of death, or the amount the member would have received at age 50, or the amount the member was receiving if retired with a duty

disability. This allowance may increase an additional 5% of FAS for each dependent child to a maximum of 60% of FAS.

Survivors may also receive a \$150,000 payment if the member dies in service or from injuries sustained in the commission of duties.

The survivor benefit for inactive members, if the spouse is married to the member at least 1 year prior to retirement, is the same benefit the member received, including the allowance for children.

Post-retirement Benefits: Retired LEOFF 1 members are provided necessary medical services by their employer (this does not include spousal coverage).

Retired members may work for any non-LEOFF employer without a reduction of benefits.

LEOFF 1 retirement benefits are fully indexed to the annual changes in the Seattle CPI-W.

Federal Benefits: There are also benefits provided by sources outside the LEOFF 1 plan. The U.S. Department of Justice, Bureau of Justice Assistance provides disability benefits, death benefits, and educational assistance benefits through the Public Safety Officers Benefits Program.

History

Five bills went before the 2004 legislature dealing with LEOFF 1 pension issues. Two of the bills were related to the 60% cap on FAS used in determining a member's maximum retirement benefit. HB 2416 proposed raising the limit to 70% of FAS, and HB 2914 proposed eliminating the cap entirely; both bills received a hearing but neither moved from committee. HB

3114 / SB 6355 dealt with disability boards; they did not pass out of either fiscal committee. The remaining bills dealt with survivor benefits (HB 3173), and establishing medical accounts to help employers pay for catastrophic illnesses (HB 3174); neither received a hearing. These legislative proposals will be discussed in the “Issues” section of this report.

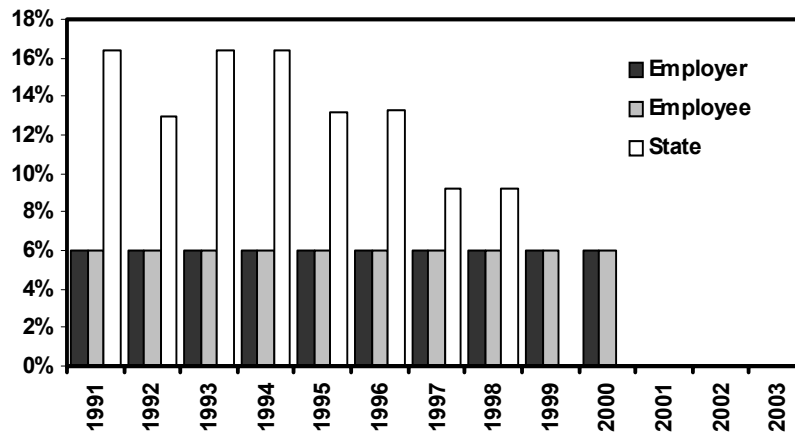
The following is a list of the most recent LEOFF 1 legislation sponsored by the former Joint Committee on Pension Policy (JCPP) to pass into law.

Year	Session Law	Subject
2003	Ch 030 L 03	Disability boards
2003	Ch 032 L 03	Fallen Hero survivor benefits
2002	Ch 158 L 02	Survivor benefits
2000	Ch 186 L 00	Survivor option flexibility
1999	Ch 134 L 99	Death benefits
1998	Ch 157 L 98	\$150,000 death benefit
1997	Ch 122 L 97	Portability

Funding Sources

At this time, no contributions are being made to the LEOFF 1 retirement plan. State contributions were suspended in July, 1999, and member and employer contributions were suspended in May, 2000. The plan had actually reached fully funded status in 1997. When contributions were being made to LEOFF 1, statutes required members and employers both to contribute 6% of salary. The State then contributed the required costs of the system in excess of those met by the members and employers. In many years the State contribution was well above the member and employer contributions (see Figure 1).

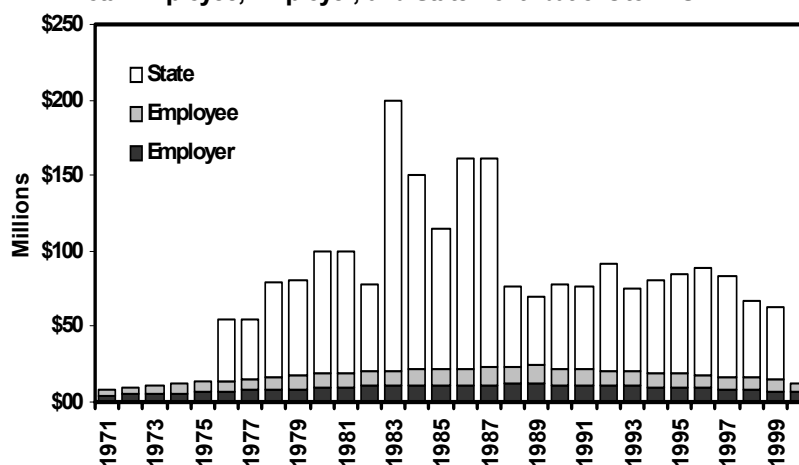
Figure 1
Employer, Employee, and State Contribution Rates to LEOFF 1



Source: Office of the State Actuary

The First Actuarial Valuation of the Washington Law Enforcement Officers' and Fire Fighters' Retirement System, submitted to the Public Employees' Retirement System and forwarded to the Governor in October of 1970, recommended that the State contribute 33.16% of pay. In the first 5 years of its existence, however, the State made no contributions to LEOFF 1 (see Figure 2). But beginning in 1976, and continuing through 1999, annual State contributions were significantly above the employer and employee contributions, averaging just over 40% of pay (see Appendix B).

Figure 2
Total Employee, Employer, and State Contributions to LEOFF 1

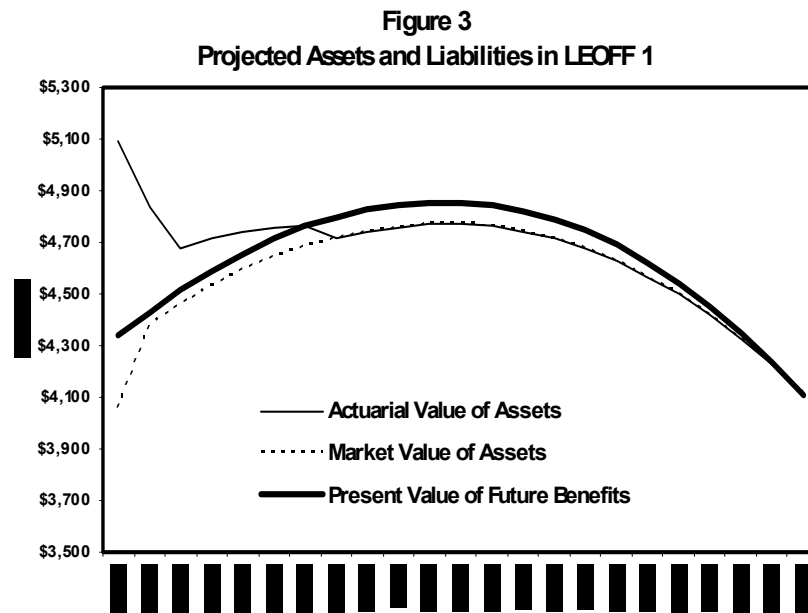


Source: Consolidated Annual Financial Reports

Funding Ratio

As of the 2003 valuation, LEOFF 1 had a funded ratio of 112%, meaning there were \$1.12 in actuarial assets for every \$1.00 of liabilities. The funding ratio had changed very little between 1987 and 1994, hovering in the mid-60% range. Beginning in 1995, thanks to the outsized market returns, continued contributions, and low inflation, that funded ratio began increasing. By 2000, in conjunction with the new valuation interest rate which increased from 7.5% to 8.0%, the LEOFF 1 funding ratio peaked at 136%.

Based on current projections, the plan is expected to emerge from its surplus position in the 2009-2011 biennium (see Figure 3). Poor market performance on the plan assets in 2000-2002, and no contributions over the past several years are the primary cause. Still, the assets and liabilities of the plan are tracking very closely; even when the assets dip below the liabilities, the funded ratio is not expected to fall below 99%. Future forecasts, which will recognize more recent market performance, may show different results.



When the plan does exhaust its surplus, contribution rates from employers and employees will resume, albeit on the relatively small payroll that remains. Then, depending on the funded status of the plan, State contributions may resume as well.

ISSUES

The following sections will include brief background discussions, policy implications, and fiscal impact of the various legislative proposals forwarded to the legislature in the last session. A final issue deals with the contribution rate holiday; it has not been addressed in any previous legislative proposal.

Survivor Benefits

Survivor benefits provide ongoing retirement income to a designated beneficiary after the death of the original member. For the survivor of a LEOFF 1 member who died prior to retirement, the benefit is 50% of the member's FAS, with 5% per child allotments to a maximum of 60% of FAS. These benefits are provided to eligible survivors as part of the plan design, i.e. at no additional cost to the member.

If a LEOFF 1 member dies in service or from injuries sustained in the commission of duties, survivors also receive a \$150,000 lump-sum from the plan.

Spouses of active LEOFF 1 members are eligible for a survivor benefit regardless of how long they had been married. Spouses of terminated vested members who have at least 20 years of service credit, spouses of duty disability retirees, and spouses of service retirees must have been married to the member at least one year before the member's separation from service to be eligible for an unreduced survivor benefit.

Ex-Spouse Survivor Benefits: Ex-spouses of LEOFF 1 members may also qualify for survivor benefits if they divorced prior to the member's separation from service and entered into a court order or court approved property settlement after July 1, 2003. In such an instance, the ex-spouse may be awarded a portion of the member's benefit and survivor benefit if that benefit is so designated in the order or settlement

Earlier provisions in LEOFF 1 required ex-spouses to meet stringent criteria to be eligible for survivor benefits. Prior to 1980, ex-spouses could only qualify if they had been married to the member for 30 years, 20 of which were before the member retired. More recently, an ex-spouse could qualify if the member had 30 years of service and they had been married at least 25 years. The benefit

for a spouse who divorced and entered into property settlement prior to July 1, 2003 will cease upon the death of the member. Even a spouse who divorced after 40 years of marriage would not qualify for continuing benefits if the member had less than 30 years of service.

Post Retirement Marriage Survivor Benefits : In an option that was established under 2002 legislation, and has never been offered before (even in prior act plans that were closed with the implementation of LEOFF 1) members who marry after retirement may designate their new spouse as a beneficiary. Members may do so during a one-year window that begins one year after the date of marriage. To make such a designation, there may not be a qualified ex-spouse receiving a portion of the member's retirement benefit under a court approved property settlement. To receive this benefit the member's allowance is actuarially reduced. A member can chose among several survivor options in which a specific percent of their adjusted allowance is passed on to their survivor. Figure 4 illustrates the joint and survivor options for a current service retiree who is 5 years older than their spouse. Option factors are found in Appendix C.

Figure 4
LEOFF 1 Survivor Allowance Options:
Member 5 Years Older than Spouse

Option	Factor	Joint Benefit	Survivor Benefit
Single Life	1.000	\$3,642*	\$0
Joint & 50%	0.921	\$3,354	\$1,677
Joint & 66⅔%	0.898	\$3,271	\$2,181
Joint & 100%	0.854	\$3,110	\$3,110

* \$3,642 is the average service retiree benefit per month for new service retirees as of the 2003 valuation

Recent Legislation: HB 3173 was introduced in the 2004 legislative session. It would have amended the post retirement spousal survivor benefit so that a spouse from a post-retirement marriage could receive a survivor benefit even though there may be a qualified ex-spouse receiving a portion of the member's retirement benefit under a court approved property settlement. The bill did not receive a hearing.

Legislative Interest: While there has been no recent legislation, there is interest in acting on the ex-spouse survivor benefits issue (see Morton's letter as attachment). As noted, benefits to many ex-spouses may cease after the member's death. This has the effect of removing a significant income source to those who may have no alternatives.

Policy Considerations: Implicit retirement policies outlined by the former Joint Committee on Pension Policy state that "Pension benefits should meet the needs of employees, retirees and employers within available resources," and "Retirees should have more flexibility in determining the form and timing of their benefit." The provisions allowing ex-spouses and spouses from post-retirement marriages to receive survivor benefits are based on these policies. Any expansion of eligibility for multiple survivors to receive fractional benefits via an actuarial reduction to the member's benefit would not be in conflict with these policies.

Fiscal Impact: As the benefits are actuarially reduced, there would be no fiscal impact (Fiscal notes are found in Appendix D), but the addition of new beneficiaries would have an administrative impact on the Department.

Contributions to Medical Accounts

When the LEOFF 1 plan reach fully-funded status, contribution rates were suspended for employees, employers, and the State. This represented a savings for employers and the State, and a pay increase for members. A supplemental retirement benefit funded using all or a portion of monies saved from the suspension of contribution rates would not be unprecedented, but some benefit proposals may have some unresolved tax implications.

Recent Legislation: HB 3174 was introduced in the 2004 legislative session. Its aim was to establish medical accounts using contribution savings of employers and members to help employers pay for catastrophic illnesses of members or beneficiaries. The bill did not receive a hearing.

Policy Considerations: Retiree medical accounts are governed by IRS code that requires specific funding levels of the underlying pension plan (120%-125%) prior to creation, and limits the amount of contributions to such accounts. It is uncertain that such contributions required under HB 3174 would be covered under existing IRS code; tax counsel would need to be consulted. Bill language calls for the money in these accounts to be used for

the “catastrophic medical expenses of employers for the benefit of members or beneficiaries...” Currently, necessary medical services to LEOFF 1 retirees are provided by each member’s employer. This bill would provide catastrophic medical expense coverage to beneficiaries that has not previously been available.

Fiscal Impact: There is no fiscal impact on the retirement plan, but if instituted in 2005, there would be an \$8 million long-term impact on both members and employers and an administrative impact on the Department.

Disability Board Membership

Decisions on eligibility for LEOFF 1 disability and medical benefits are made by city and county LEOFF 1 disability boards. Disability benefits may be granted for both duty and non-duty disabilities.

Each city with a population of 20,000 or more has a LEOFF 1 disability board. Each county also has a disability board, and these county boards have jurisdiction over LEOFF 1 members not covered by a city disability board. Under current law, one of the members of a county board must be a member of the legislative body of a city or town in the county that does not have its own board. This member must be chosen by a majority of the mayors of the affected cities or towns.

Fire fighter and law enforcement officers serving on the disability boards are elected by LEOFF 1 members. All members of LEOFF Plan 1 and 2 may serve on disability boards, but only LEOFF 1 members may vote to elect the LEOFF members.

Other disability board members are not required to be LEOFF 1 members.

There are currently fewer than 1,000 active members, and in a few years there will be very few. When the last active LEOFF 1 member retires, and when all disabled LEOFF 1 members reach age 60, the disability boards may be discontinued. Until then, they are necessary.

Declining numbers of active members has already resulted in situations that cannot be accommodated under existing disability board membership provisions. Board membership is to include one active or retired police officer,

and one active or retired fire fighter. Among these remaining active and retired members in certain jurisdictions there may be no fire fighters, or no police officers. Current disability board membership provisions are not crafted to accommodate these circumstances.

Recent Legislation: Companion bills HB 3114 and SB 6355 were introduced in the 2004 session to deal with LEOFF 1 disability board membership. The bills would have clarified the qualifications of the active or retired fire fighters and active or retired law enforcement officers who are eligible to serve on the county disability board and who are eligible to vote for those board members; these persons must be active or retired from a legislative authority within the county subject to the jurisdiction of that same county's disability board. The bills also required that if there were either no fire fighters or no law enforcement officers eligible to vote, the eligible fire fighters or law enforcement officers would elect a second board member. Neither bill was forwarded from its respective fiscal committee.

Policy Consideration: Each disability board is required to have two LEOFF members. This legislation does not establish any new policies in regards to that membership but merely fine-tunes that policy in light of the declining number of eligible LEOFF 1 voting members. This issue will probably need to be visited again as the number of LEOFF 1 members declines even further.

Fiscal Impact: None

60% Benefit Cap

When first founded, LEOFF 1 had no benefit cap. With the passage of Chapter 120, laws of 1974, members' benefits were capped at 60% of final average salary. Those hired into LEOFF 1 positions on or after February 19, 1974 -- the effective date of the act -- are subject to the 60% cap; those hired prior to that date are not. As of the 2003 valuation, 507 of the 991 remaining active members were subject to the 60% benefit cap.

Of the total 8,054 retirees, 2,344 became members prior to February 19, 1974. Of those, 659 had a benefit that was greater than 60% of their final average salary.

The Public Employees' Retirement System (PERS) plan 1 and the Teachers' Retirement System (TRS) plan 1 both have provisions capping retirement benefits at 60% of average final compensation (AFC).

The plans 2/3, including LEOFF 2, have no benefit cap, but they are age-based plans as opposed to service-based plans. The School Employees' Retirement System (SERS), PERS and TRS 2/3 require members to be age 65 in order to receive an unreduced defined benefit. LEOFF 2 requires members to be age 53 to receive an unreduced benefit compared to age 50 in LEOFF 1.

In addition, all the plans 2/3 use a 60 month period to determine a member's final average salary (LEOFF) or average final compensation (PERS, SERS, TRS) when calculating their retirement allowance. PERS 1 and TRS 1 use a 24 month average, and LEOFF 1 members may use a 12 month average.

Recent Legislation: Two bills were introduced during the last legislative session related to the 60% cap in LEOFF 1. HB 2416 proposed raising the limit to 70% of FAS, and HB 2914 proposed eliminating the cap entirely; both bills received a hearing but neither moved from committee.

Policy Considerations: One of the general policies found in the funding chapter (RCW 41.45) is "Fund, to the extent feasible, benefit increases for all plan members over the working lives of those members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service." The average age of remaining active LEOFF 1 members is 54 years, and their average member service is 29.3 years. For a plan that wasn't fully funded, there would be scant time to contribute to a benefit increase for an active membership that is already, on average, retirement eligible. Because LEOFF 1 is in surplus status at this time, any benefit increase would draw on that surplus.

The other policy concern would be leapfrogging. One of the common criticisms of the plan 1 design is the 30 year cap or 60% cap; member's benefits are a maximized at 30 years of service ($2\% \times 30$ years of service = 60% of AFC). Were the cap raised or eliminated in the LEOFF 1 plan, PERS 1 and TRS 1 members may request a similar benefit increase which would have a much higher cost.

Fiscal Impact: The fiscal note for HB 2416 stated that the present value of projected benefits would increase by \$16 million, and the State contribution rate, when it is projected to resume, would increase by 0.14 percentage points.

The fiscal note for HB 2914 stated that the present value of projected benefits would increase by \$19 million and the State contribution rate, when it is projected to resume, would increase by 0.17 percentage points.

Based on forecasts from the 2002 valuation, the LEOFF 1 plan would emerge from its fully funded status in the 2011-2013 biennium. Fiscal notes showed that these proposals would result in the plan emerging from full funding one biennium earlier than projected.

Because of its relatively small surplus, the funding needs of LEOFF 1 are sensitive to short-term market performance. Plan assets and liabilities are tracking very closely. Future forecasts, which will recognize more recent market performance, may show different results.

Contribution Holiday

Because of its fully funded status, employer, member, and state contributions to the LEOFF 1 plan have been suspended. As a result, active members are earning benefits while not making contributions, in essence receiving a 6% pay raise. The state and LEOFF employers are also able to use monies that would have been used for retirement contributions for other purposes. Because projections show the LEOFF 1 plan emerging from full funding in the 2011-2013 biennium, there has been a discussion to resume contributions to prevent that from occurring.

Policy Considerations: Funding policies in Washington State, as outlined in RCW 41.45.010(3), include the goal to “To establish predictable long-term employer contribution rates which will remain a relatively constant proportion of the future state budgets” While the suspension of contributions in LEOFF 1 would appear to be in conflict with that policy, that policy is difficult to apply in a fully funded closed plan with a small and declining number of active members. As the obligation to amortize the LEOFF 1 unfunded liability was fulfilled, and as the plan reached fully funded status, the state established a new funding policy to acknowledge that funded status.

Defined benefit retirement plans are funded to support the benefit provisions within the plans. Ideally the funded ratio of such plans would always be at 100%, where assets match liabilities. Funding policies are formulated to reach that goal. It is not the goal of existing funding policy for any Washington State retirement system or plan to have surplus funding on a long-term basis. That

would mean that the actuarial assumptions were too conservative relative to the experience of the plan. In turn, that would mean members and employers were paying too much for the existing benefits.

Stakeholder Input

Senator Bob Morton
7th Legislative District
See attached correspondence

Richard Warbrouck
President, Retired Fire Fighters of Washington
See attached correspondence

Appendix A

Law Enforcement Officers' and Fire Fighters' plan 1 Provisions

Design

Defined benefit retirement, disability and medical plan.

Membership

Mandatory for full-time, fully compensated:

- (1) Law enforcement officers (i.e., county sheriffs, deputy sheriffs who have passed a civil service examination, city police officers, town or deputy marshals, or certain directors of public safety);
- (2) Fire fighters (i.e., persons who have successfully passed a civil service examination, if required, for fire fighter or supervisory fire fighter); and
- (3) Specified commissioned officers enforcing the criminal laws of the state who were employed on or before September 30, 1977.

Eligibility for membership generally requires meeting certain minimum medical, health, and age standards. Exclusions from the age standard are granted for police chiefs, fire chiefs, sheriffs, and certain directors of public safety.

Portability

Former LEOFF 1 members who become members of PERS, TRS or WSP may transfer their prior LEOFF 1 service to their current retirement system. Upon transfer, all ties with LEOFF 1 are severed, including eligibility for post-retirement medical benefits.

Vesting

Established upon completion of five years of credited service.

Terminated, Vested Benefit

(Terminates, but maintains membership by not withdrawing contributions)

At age-50, a terminated, vested member may receive a service retirement allowance.

If a terminated, vested member dies prior to attaining age-50 and with less than 20 years of service, a refund of contributions and accrued interest is made to the surviving spouse, designated beneficiary or personal representative of the estate.

If a terminated, vested member dies with at least 20 years of service, the benefit is as though the member had died in service.

Credited Service

- (1) A service credit month is earned for each calendar month of employment for which compensation is paid for 70 or more hours.
- (2) Service credit is also earned for:
 - (a) Periods of suspension up to 30 days; and
 - (b) Periods of disability leave if the member returns to duty.

Service Credit for Leave of Absence

A member who is on paid leave of absence will receive service credit for such leave. This applies to a member, as authorized by a collective bargaining agreement, who serves as an elected official of a labor organization.

Military Service Credit

Members whose service is interrupted receive up to five years of military service.

Withdrawal of Employee Contributions

Upon termination of employment for reasons other than retirement or disability a member may sever relationship with the system by withdrawing his or her contributions, plus accrued interest thereon.

Restoration/Purchase of Service Credit

Contributions restored within 5 years of re-entry, member repays the withdrawn amount.

Contributions restored after 5 years, member pays full actuarial value of restored service.

Compensation

The basic monthly rate of salary or wages, including longevity pay but not including overtime earnings or special salary or wages. (Defined as basic salary.)

Computation of Final Average Salary

The basic salary attached to the position or rank at retirement if held for at least 12 months. If not, it is the average of the greatest basic salaries paid over 24 consecutive credited months in the last 10 credit years.

Eligibility for Normal Retirement

Five years of service and attainment of age-50.

Service Retirement Allowance

- (1) 1% of final average salary (FAS) for each year if the member has at least five years of service, but less than ten years of service.
- (2) 1.5% of FAS for each service credit year if the member has at least ten, but less than 20 years of service.
- (3) 2% of FAS for each year of service if the member has 20 or more years of service.
- (4) The benefit shall not exceed 60% of FAS if the member was first employed on or after February 19, 1974.

Cost-of-Living Adjustments

Each April 1st, after one year of retirement, an annual adjustment is made to the benefit based upon the percentage difference between the CPI-Seattle, for the previous year and the CPI-Seattle, for the year prior to retirement.

Retirement for Disability

Duty/Non-Duty: With the approval of the local disability board and the Director, DRS, a member who has incurred a disability rendering him or her unable to continue service in the position or rank held at that time, shall receive an allowance of 50% of FAS, plus an additional five percent of FAS for each dependent child, not to exceed a maximum benefit of 60% of FAS.

Disability Leave

As ordered by the local disability board, the employer provides up to six months of leave at full pay.

Survivor Benefits - Active Members

- (1) The surviving spouse receives an allowance equal to what the member would have received at age-50 (50% of AFC), plus five percent additional for each child, with the maximum benefit not to exceed 60%.

If there is no surviving spouse but there are children, the first surviving child receives an allowance equal to 30% of FAS, and an additional 10% for each additional child to a maximum of 60%. The payments will be prorated among them.

- (2) If member dies in service or from injuries sustained in the commission of duties - survivors receive a \$150,000 lump sum payment.

Survivor Benefits - Retired Members

The surviving spouse, if married one year to the member prior to retirement, receives the same benefit as did the member, including the allowance for children. If there is no surviving spouse but there are children, the first surviving child receives an allowance equal to 30% of FAS, and an additional 10% for each additional child to a maximum of 60%. The payments will be prorated among them.

Medical Services

Necessary medical services are provided by the employer to active and retired members.

Post-Retirement Employment

Members may work for any non-LEOFF employer without a reduction of benefits.

Member Contributions

- (1) 6% of compensation (i.e., basic salary).
- (2) Contributions are required only when the plan's most recent actuarial valuation indicates an unfunded liability exists.
- (3) Employee contributions may be "picked-up" for all employees of an employer under Section 414(h) of the IRS Code.

Employer Contributions

- (1) 6% of compensation (i.e, basic salary).
- (2) Contributions are required only when the plan's most recent valuation indicates an unfunded liability exists.
- (3) The present value of the total estimated cost of all benefits attributed to excess compensation.

Excess compensation includes any payment on which the calculation of the retirement allowance is made, except basic salary.

State Contributions

The required costs of the system in excess of those met by the contributions of the employee and employer. This includes the amortization of the unfunded liability by June 30, 2024.

Appendix B

LEOFF 1 Statement of Changes in Plan Net Assets

For Years Ending June 30th

Fiscal year	Market Assets * (end of year)	Contributions				State contribution as a % of salary	Fiscal year disbursements
		Employee	Employer	State	Total		
1970	\$10,783,000	-----	-----	-----	-----	-----	
1971	\$19,929,181	\$4,285,260	\$4,285,260	\$0	\$8,570,520	-----	\$1,634,650
1972	\$33,829,038	\$4,907,850	\$4,907,850	\$0	\$9,815,700	-----	\$4,209,500
1973	\$43,336,391	\$5,382,510	\$5,382,510	\$0	\$10,765,020	-----	\$6,592,500
1974	\$57,914,979	\$5,916,300	\$5,916,300	\$0	\$11,832,600	-----	\$9,180,750
1975	\$77,564,804	\$6,509,220	\$6,509,220	\$0	\$13,018,440	-----	\$11,974,250
1976	\$109,980,394	\$7,132,023	\$7,132,023	\$39,810,356	\$54,074,402	33.5%	\$14,921,451
1977	\$161,894,099	\$7,773,699	\$7,773,699	\$39,689,644	\$55,237,042	30.6%	\$18,022,354
1978	\$226,227,684	\$8,396,502	\$8,565,528	\$62,668,321	\$79,630,351	44.8%	\$21,396,921
1979	\$295,568,391	\$8,738,973	\$8,778,495	\$62,478,300	\$79,995,768	42.9%	\$26,153,565
1980	\$393,207,886	\$9,241,014	\$9,321,517	\$81,694,026	\$100,256,557	53.0%	\$32,660,419
1981	\$496,916,357	\$9,593,000	\$9,585,000	\$81,166,000	\$100,344,000	50.8%	\$40,441,000
1982	\$522,976,635	\$10,400,633	\$10,391,118	\$56,729,347	\$77,521,098	32.7%	\$50,393,815
1983	\$732,684,842	\$10,561,209	\$10,530,515	\$178,057,262	\$199,148,986	101.2%	\$58,947,576
1984	\$886,463,945	\$10,791,349	\$10,734,238	\$128,749,878	\$150,275,465	71.6%	\$65,127,565
1985	\$1,034,190,679	\$10,926,267	\$10,857,000	\$93,146,449	\$114,929,716	51.2%	\$69,279,352
1986	\$1,207,993,114	\$11,004,730	\$10,893,557	\$139,122,916	\$161,021,203	75.9%	\$74,681,582
1987	\$1,789,837,346	\$11,432,053	\$11,365,919	\$138,443,471	\$161,241,443	72.7%	\$79,979,069
1988	\$1,843,529,858	\$11,709,770	\$11,676,523	\$52,522,735	\$75,909,027	26.9%	\$84,536,118
1989	\$2,055,809,053	\$11,987,486	\$11,987,126	\$46,249,232	\$70,223,844	23.1%	\$90,927,845
1990	\$2,188,850,541	\$10,675,028	\$10,611,947	\$56,787,848	\$78,074,823	31.9%	\$98,444,768
1991	\$2,336,825,596	\$10,931,945	\$10,763,500	\$54,403,718	\$76,099,163	29.9%	\$109,091,107
1992	\$2,494,326,109	\$10,436,729	\$10,427,591	\$70,333,321	\$91,197,641	40.4%	\$122,097,650
1993	\$2,755,829,928	\$10,465,916	\$10,393,893	\$54,664,315	\$75,524,124	31.3%	\$134,561,317
1994	\$2,748,629,232	\$9,801,400	\$9,794,758	\$61,289,136	\$80,885,294	37.5%	\$146,215,486
1995	\$3,112,599,913	\$9,467,354	\$9,484,269	\$65,468,874	\$84,420,497	41.5%	\$157,754,206
1996	\$3,575,812,041	\$8,923,558	\$8,935,270	\$70,913,900	\$88,772,728	47.7%	\$170,546,109
1997	\$4,170,300,827	\$8,184,875	\$8,190,404	\$66,746,617	\$83,121,896	48.9%	\$184,119,302
1998	\$4,715,767,752	\$8,341,376	\$7,566,542	\$50,358,280	\$66,266,198	36.2%	\$200,532,887
1999	\$5,113,605,449	\$7,165,640	\$7,195,563	\$48,793,478	\$63,154,681	40.9%	\$216,688,665
2000	\$5,550,458,331	\$6,323,611	\$6,302,777	\$0	\$12,626,388	0.0%	\$228,241,279
		\$267,407,280	\$266,259,912	\$1,800,287,424	\$2,333,954,615	40.4%	\$2,529,353,058
		11.5%	11.4%	77.1%			

Source: Department of Retirement Systems, Comprehensive Annual Financial Reports (1976 - 2000), Washington Law Enforcement Officers' and Firefighters' Retirement System Actuarial Valuations (1970-1975)

Note: Midpoint averaging used to estimate missing data for asset accounts, disbursements, and salaries used in turn to estimate employee and employer contributions.

* Book value assets prior to 1981.

Appendix C

LEOFF 1 Survivor Option Factors

Member younger than beneficiary				Member older than beneficiary			
Age Difference	Option 2 100%	Option 3 50%	Option 4 66 2/3 %	Age Difference	Option 2 100%	Option 3 50%	Option 4 66 2/3 %
-20	0.958	0.978	0.971	0	0.878	0.935	0.915
-19	0.955	0.977	0.969	1	0.873	0.932	0.912
-18	0.952	0.975	0.967	2	0.868	0.930	0.908
-17	0.949	0.974	0.965	3	0.864	0.927	0.905
-16	0.946	0.972	0.963	4	0.859	0.924	0.901
-15	0.942	0.970	0.961	5	0.854	0.921	0.898
-14	0.939	0.969	0.959	6	0.849	0.918	0.894
-13	0.935	0.967	0.956	7	0.844	0.915	0.890
-12	0.932	0.965	0.953	8	0.839	0.913	0.887
-11	0.928	0.963	0.951	9	0.835	0.910	0.883
-10	0.924	0.960	0.948	10	0.830	0.907	0.880
-9	0.920	0.958	0.945	11	0.826	0.905	0.877
-8	0.916	0.956	0.942	12	0.821	0.902	0.873
-7	0.911	0.954	0.939	13	0.817	0.899	0.870
-6	0.907	0.951	0.936	14	0.813	0.897	0.867
-5	0.902	0.949	0.933	15	0.809	0.894	0.864
-4	0.898	0.946	0.929	16	0.805	0.892	0.861
-3	0.893	0.943	0.926	17	0.801	0.889	0.858
-2	0.888	0.941	0.922	18	0.797	0.887	0.855
-1	0.883	0.938	0.919	19	0.793	0.885	0.852
				20	0.790	0.882	0.849
				21	0.786	0.880	0.847
				22	0.783	0.878	0.844
				23	0.780	0.876	0.841
				24	0.777	0.874	0.839
				25	0.774	0.872	0.837
				26	0.771	0.871	0.834
				27	0.768	0.869	0.832
				28	0.765	0.867	0.830
				29	0.763	0.865	0.828
				30	0.760	0.864	0.826
				31	0.758	0.862	0.824
				32	0.756	0.861	0.823
				33	0.753	0.859	0.821
				34	0.751	0.858	0.819
				35	0.749	0.857	0.818
				36	0.747	0.855	0.816
				37	0.745	0.854	0.815
				38	0.744	0.853	0.813
				39	0.742	0.852	0.812
				40	0.740	0.851	0.810

Age difference: Member age minus beneficiary age

[Statutory Authority: RCW 41.50.050(5), 41.26.162, 41.26.164, chapter 41.45 RCW. 03-12-014, § 415-02-380, filed 5/27/03, effective 7/1/03. Statutory Authority: RCW 41.50.050(5) and chapter 41.45 RCW. 03-02-087, § 415-02-380, filed 12/31/02, effective 2/1/03; 02-18-048, § 415-02-380, filed 8/28/02, effective 9/1/02.]

Appendix D

FISCAL NOTE

REQUEST NO.

RESPONDING AGENCY:	CODE:	DATE:	BILL NUMBER:
Office of the State Actuary	035	1/20/04	HB 2416

SUMMARY OF BILL:

This bill impacts the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1) by increasing the maximum service retirement allowance of those who became members on or after February 19, 1974 to 70% of their final average salary.

Effective Date: 90 days after session

CURRENT SITUATION:

Currently, the maximum service retirement allowance for a member of LEOFF 1 who became a member on or after February 19, 1974 is 60% of their final average salary.

MEMBERS IMPACTED:

We estimate that 568 active members hired on or after 2/19/1974 out of the total 1,147 active members of this plan could be affected by this bill. Additional members could be affected if they returned to work and earn over 30 years of service.

Each year of additional service credit beyond 30 years, but less than 35, would result in an increase of about \$1,400 in annual pension payments per person (based on a current annual salary of \$69,667).

ASSUMPTIONS:

We have assumed that future disabled retirees with at least 30 years of service will elect the proposed service retirement benefit (with the 70% of pay cap) in lieu of the 50% of the pay tax-free disability benefit. The impact of this assumption change, as it relates to the proposed service retirement benefit, is reflected in the estimated cost of this proposal. This proposed benefit change may alter future retirement behavior in the plan and, as a result, have an additional impact on the plan's liability. This cost, if it indeed materializes, would be reflected in future actuarial valuations after retirement rates are adjusted for any change in actual retirement experience.

FISCAL IMPACT:

Description:

There is no immediate fiscal impact while the plan remains in a surplus or fully funded position. However, the plan is projected to resume funding earlier and at a higher rate as a result of the proposed benefit increase.

Actuarial Determinations:

The bill will impact the actuarial funding of the system by increasing the present value of benefits payable under the System and the required actuarial contribution rate as shown below:

Law Enforcement Officers' and Fire Fighters' Retirement System:			
<i>(Dollars in Millions)</i>	Current	Increase	Total
Actuarial Present Value of Projected Benefits (The Value of the Total Commitment to all Current Members)	\$4,338	\$16	\$4,354
Unfunded Actuarial Accrued Liability (The Portion of the Plan 1 Liability that is Amortized at 2024)	\$(757)	\$16	\$(741)
Unfunded Liability (PBO) (The Value of the Total Commitment to all Current Members Attributable to Past Service)	\$(830)	\$13	\$(817)

Increase in Contribution Rates: (Effective 9/01/2004)

Employee	0.0%
Employer State	0.0%

Fiscal Budget Determinations:

As a result of the higher required contribution rate, the increase in funding expenditures is projected to be:

Costs (in Millions):

2004-2005

State:

General Fund	\$0.0
Non-General Fund	<u>0.0</u>

Total State **\$0.0**

Local Government \$0.0

Total Employer \$0.0

Total Employee \$0.0

2005-2007

State:

General Fund	\$0.0
Non-General Fund	<u>0.0</u>

Total State **\$0.0**

Local Government \$0.0

Total Employer \$0.0

Total Employee \$0.0

2004-2029

State:

General Fund	\$53.7
Non-General Fund	<u>0.0</u>

Total State **\$53.7**

Local Government \$1.6

Total Employer \$55.3

Total Employee \$1.6

State Actuary's Comments:

Because the plan is currently in a surplus position, we have projected the impact this bill might have on the plan's future funding status. This projection reflects the future recognition of prior asset gains and losses and the impact of this proposed plan change. The plan's actual funded status will vary depending on the plan's actual experience and could easily be different than projected over the short-term.

Based on this projection, the plan is expected to emerge from its surplus position in the 2011-2013 biennium before this plan change. After the plan change, the plan is expected to emerge from its surplus position in 2009-2011. This would result in 6% employee and employer contributions for Plan 1 members resuming two years earlier. The state's normal cost contribution for Plan 1 members would also resume 2 years earlier, but more significantly the state's UAAL contribution over all LEOFF members pay would resume earlier and at a rate that is approximately .14% higher.

STATEMENT OF DATA AND ASSUMPTIONS USED IN PREPARING THIS FISCAL NOTE:

The costs presented in this fiscal note are based on our understanding of the bill as well as generally accepted actuarial standards of practice including the following:

1. Costs were developed using the same membership data, methods, assets and assumptions as those used in preparing the September 30, 2002 actuarial valuation report of the Law Enforcement Officers' and Fire Fighters' Retirement System.
2. As with the costs developed in the actuarial valuation, the emerging costs of the System will vary from those presented in the valuation report or this fiscal note to the extent that actual experience differs from that projected by the actuarial assumptions.
3. Additional assumptions used to evaluate the cost impact of the bill which were not used or disclosed in the actuarial valuation report or in this fiscal note include the following: None.
4. The analysis of this bill does not consider any other proposed changes to the system. The combined effect of several changes to the system could exceed the sum of each proposed change considered individually.
5. This fiscal note is intended for use only during the 2004 Legislative Session.
6. The funding method used for Plan 1 utilizes the Plan 2/3 employer/state rate as the Normal Cost and amortizes the remaining liability (UAAL) by the year 2024. Benefit increases to Plan 2/3 will change the UAAL in Plan 1. The cost of benefit increases to Plan 1 increases the UAAL.
7. Plan 2/3 utilizes the Aggregate Funding Method. The cost of Plan 2/3 is spread over the average working lifetime of the current active Plan 2/3 members.

GLOSSARY OF ACTUARIAL TERMS:

Actuarial Present Value: The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of Actuarial Assumptions (i.e. interest rate, rate of salary increases, mortality, etc.)

Projected Benefits: Pension benefit amounts which are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

Normal Cost: Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

Unfunded Actuarial Accrued Liability (UAAL): The cost of Plan 1 is divided into two pieces:

- The Normal Cost portion is paid over the working lifetime of the Plan 1 active members. The remaining cost is called the UAAL.
- The UAAL is paid for by employers as a percent of the salaries of all plan 1, 2 and 3 members until the year 2024.

Pension Benefit Obligation (PBO): The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service).

Unfunded Liability (Unfunded PBO): The excess, if any, of the Pension Benefit Obligation over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

FISCAL NOTE

REQUEST NO.

RESPONDING AGENCY:	CODE:	DATE:	BILL NUMBER:
Office of the State Actuary	035	1/23/04	HB 2914

SUMMARY OF BILL:

This bill impacts the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1) by removing the provision that limits the retirement allowance for those who became members on or after February 19, 1974 to 60% of their final average salary.

Effective Date: 90 days after session

CURRENT SITUATION:

Currently, the maximum retirement allowance for a member of LEOFF 1 who became a member on or after February 19, 1974 is 60% of their final average salary. Those who became members before February 19, 1974 have no such limit on their retirement allowance.

MEMBERS IMPACTED:

We estimate that 568 active members hired on or after 2/19/1974 out of the total 1,147 active members of this plan could be affected by this bill. Additional members could be affected if they returned to work and earn over 30 years of service.

Each year of additional service credit beyond 30 years would result in an increase of about \$1,400 in annual pension payments per person (based on a current annual salary of \$69,667).

ASSUMPTIONS:

We have assumed that future disabled retirees with at least 30 years of service will elect the proposed service retirement benefit in lieu of the 50% of the pay tax-free disability benefit. The impact of this assumption change, as it relates to the proposed service retirement benefit, is reflected in the estimated cost of this proposal. This proposed benefit change may alter future retirement behavior in the plan and, as a result, have an additional impact on the plan's liability. This cost, if it indeed materializes, would be reflected in future actuarial valuations after retirement rates are adjusted for any change in actual retirement experience.

FISCAL IMPACT:

Description:

There is no immediate fiscal impact while the plan remains in a surplus or fully funded position. However, the plan is projected to resume funding earlier and at a higher rate as a result of the proposed benefit increase.

Actuarial Determinations:

The bill will impact the actuarial funding of the system by increasing the present value of benefits payable under the System and the required actuarial contribution rate as shown below:

Law Enforcement Officers' and Fire Fighters' Retirement System:			
<i>(Dollars in Millions)</i>	Current	Increase	Total
Actuarial Present Value of Projected Benefits (The Value of the Total Commitment to all Current Members)	\$4,338	\$19	\$4,357
Unfunded Actuarial Accrued Liability (The Portion of the Plan 1 Liability that is Amortized at 2024)	\$(757)	\$19	\$(738)
Unfunded Liability (PBO) (The Value of the Total Commitment to all Current Members Attributable to Past Service)	\$(830)	\$14	\$(816)

Increase in Contribution Rates:	Prior to 7/1/2009	2009-11 Biennium	After 6/30/2011*
Employee	0.0%	6.0%	0.0%
Employer	0.0%	6.0%	0.0%
State	0.0%	3.59%	0.17%

**We estimate that 6% employee and employer contributions plus the state's portion of the plan's normal cost will resume two years earlier as a result of this proposed benefit increase. The state's contribution to the plan's projected UAAL would also resume two years earlier and at a rate that is 0.17% higher.*

Fiscal Budget Determinations:

As a result of the higher required contribution rate, the increase in funding expenditures is projected to be:

Costs (in Millions):

2004-2005

State:

General Fund	\$0.0
Non-General Fund	<u>0.0</u>

Total State **\$0.0**

Local Government \$0.0

Total Employer \$0.0

Total Employee \$0.0

2005-2007

State:

General Fund	\$0.0
Non-General Fund	<u>0.0</u>

Total State **\$0.0**

Local Government \$0.0

Total Employer \$0.0

Total Employee \$0.0

2004-2029

State:

General Fund	\$63.8
Non-General Fund	<u>0.0</u>

Total State **\$63.8**

Local Government \$1.6

Total Employer \$65.4

Total Employee \$1.6

State Actuary's Comments:

Because the plan is currently in a surplus position, we have projected the impact this bill might have on the plan's future funding status. This projection reflects the future recognition of prior asset gains and losses and the impact of this proposed plan change. The plan's actual funded status will vary depending on the plan's actual experience and could easily be different than projected over the short-term.

Based on this projection, the plan is expected to emerge from its surplus position in the 2011-2013 biennium before this plan change. After the plan change, the plan is expected to emerge from its surplus position in 2009-2011. This would result in 6% employee and employer contributions for Plan 1 members resuming two years earlier. The state's normal cost contribution for Plan 1 members would also resume two years earlier, but more significantly the state's UAAL contribution over all LEOFF members pay would resume earlier and at a rate that is approximately .17% higher.

STATEMENT OF DATA AND ASSUMPTIONS USED IN PREPARING THIS FISCAL NOTE:

The costs presented in this fiscal note are based on our understanding of the bill as well as generally accepted actuarial standards of practice including the following:

1. Costs were developed using the same membership data, methods, assets and assumptions as those used in preparing the September 30, 2002 actuarial valuation report of the Law Enforcement Officers' and Fire Fighters' Retirement System.
2. As with the costs developed in the actuarial valuation, the emerging costs of the System will vary from those presented in the valuation report or this fiscal note to the extent that actual experience differs from that projected by the actuarial assumptions.
3. Additional assumptions used to evaluate the cost impact of the bill which were not used or disclosed in the actuarial valuation report or in this fiscal note include the following: None.
4. The analysis of this bill does not consider any other proposed changes to the system. The combined effect of several changes to the system could exceed the sum of each proposed change considered individually.
5. This fiscal note is intended for use only during the 2004 Legislative Session.
6. The funding method used for Plan 1 utilizes the Plan 2/3 employer/state rate as the Normal Cost and amortizes the remaining liability (UAAL) by the year 2024. Benefit increases to Plan 2/3 will change the UAAL in Plan 1. The cost of benefit increases to Plan 1 increases the UAAL.
7. Plan 2/3 utilizes the Aggregate Funding Method. The cost of Plan 2/3 is spread over the average working lifetime of the current active Plan 2/3 members.

GLOSSARY OF ACTUARIAL TERMS:

Actuarial Present Value: The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of Actuarial Assumptions (i.e. interest rate, rate of salary increases, mortality, etc.)

Projected Benefits: Pension benefit amounts which are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

Normal Cost: Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

Unfunded Actuarial Accrued Liability (UAAL): The cost of Plan 1 is divided into two pieces:

- The Normal Cost portion is paid over the working lifetime of the Plan 1 active members. The remaining cost is called the UAAL.
- The UAAL is paid for by employers as a percent of the salaries of all plan 1, 2 and 3 members until the year 2024.

Pension Benefit Obligation (PBO): The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service).

Unfunded Liability (Unfunded PBO): The excess, if any, of the Pension Benefit Obligation over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.

FISCAL NOTE

REQUEST NO.

RESPONDING AGENCY:	CODE:	DATE:	BILL NUMBER:
Office of the State Actuary	035	1/28/04	HB 3114/SB 6355

SUMMARY OF BILL:

This bill impacts the Law Enforcement Officers' and Firefighters' Retirement System (LEOFF) Plan 1. The bill addresses jurisdiction, disability board membership and eligibility to vote for employee representatives on the board. The proposed legislation provides that the jurisdiction of the county disability boards applies to all members employed by or retired from an employer within the county and not employed by a city in which a disability board is established. It also clarifies that to serve on the county disability board, a fire fighter or law enforcement officer must be employed by or retired from an employer within the county and not be employed by or retired from a city in which a disability board is established. Those voting for employee representatives on the county disability board must be employed by or retired from an employer within the county and not employed by or retired from a city in which a disability board is established. Finally, the bill addresses the election of the firefighter and law enforcement officer positions on the board and adds the following new provisions: a) if there are no firefighters eligible to vote, a second eligible employee representative shall be elected by the law enforcement officers eligible to vote, and b) if there are no law enforcement officers eligible to vote, a second employee representative shall be elected by the fire fighters eligible to vote.

Effective Date: Immediately upon passage.

CURRENT SITUATION:

Currently the county disability board's jurisdiction extends to "all members residing in the county" and not employed by a city in which a disability board is established. The limitation that the members be employed by or retired from an employer within the county is not included in the current law. Similarly, regarding eligibility to serve on the disability board, the current law requires mere residence in the county for the firefighter and police officer representatives, whereas the new law requires that the employee representatives be "employed by or retired from an employer within the county" in lieu of the residency requirement, and that they not be "employed by or retired from a city in which a disability board is established." With respect to eligibility to vote, the current law allows the following to vote: all fire fighters and law enforcement officers employed or retired from the county who are not employed by or retired from a city in which a disability board is established and who are subject to the jurisdiction of the board. The new law adds the requirement that the voting member be employed by or retired from an employer within the county who are not employed by or retired from a city in which a disability board is established and who are subject to the jurisdiction of "that" board.

FISCAL IMPACT:

None.

FISCAL NOTE

REQUEST NO.

RESPONDING AGENCY:	CODE:	DATE:	BILL NUMBER:
Office of the State Actuary	035	2/05/04	HB 3173

SUMMARY OF BILL:

This bill impacts the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1. It amends the plan provision relating to survivor benefits under RCW 41.26.164, which provides an optional reduced retirement allowance with survivor benefits to spouses that are ineligible for survivor benefits under other plan provisions. The bill changes one of the criteria for allowing a member to choose this retirement option. Under this legislation, the member could select the option as long as there is some portion of his or her retirement benefit that is not subject to a property division pursuant to a domestic relations order. (Currently, any division would defeat the member's ability to select this option.) Other provisions of the bill include a one-year extension of the deadline for promulgating rules to allow members to choose this option, and a "clean-up" provision that changes "beneficiaries" to "beneficiary's" (based on the assumption that the member has only one spouse at any given point in time).

Effective Date: 90 days after session.

CURRENT SITUATION:

Currently a member desiring to choose this option shall "have the retirement allowance payable to the retiree not subject to periodic payments pursuant to a property division obligation as provided for in RCW 41.50.670." This language is broad enough to suggest that the presence of any such division would defeat the member's ability to choose this option. With the new language, the member could choose this option so long as there is a portion of the retirement allowance that is not subject to division.

MEMBERS IMPACTED:

We have no information on the number of members whose pensions are partially divided, who have re-married and who would choose to take an actuarially reduced benefit on the remaining portion. For those who do make this election, their benefit would be actuarially reduced to reflect the cost of the survivor benefit provided by the election. For example, the option factor is .935 for a 50% Joint and Survivor option where the spouse is the same age as the member, thereby reducing a single-life benefit of \$1,000 per month to \$935 per month.

FISCAL IMPACT:

None. The member pays the full cost of the survivor benefit via an actuarial reduction of his or her retirement allowance.

FISCAL NOTE

REQUEST NO.

RESPONDING AGENCY:	CODE:	DATE:	BILL NUMBER:
Office of the State Actuary	035	2/05/04	HB 3174

SUMMARY OF BILL:

This bill impacts the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 (LEOFF 1) by establishing the Law Enforcement Officers' and Fire Fighters' Retirement System Plan 1 medical account within the office of the State Treasurer. Expenditures from this account could be used only for the catastrophic medical expenses of employers for the benefit of LEOFF 1 members **or beneficiaries**. The account would be funded by contributions from members and employers. The member contributions would be 6% of payroll less any member contributions to the retirement fund. The employer contributions would be 6% of payroll less any employer contributions to the retirement fund.

The Director of the Department of Retirement Systems is to establish the rules for receipt of distributions from this account.

Effective Date: 90 days after session.

CURRENT SITUATION:

Currently, necessary medical services to LEOFF 1 retirees are provided by each member's employer. This bill provides catastrophic medical expense coverage to beneficiaries that has not previously been available.

Because of the funding status of LEOFF 1, no member, employer, or state contributions are currently being paid into the LEOFF 1 fund. As a result, initial member and employer contributions to the proposed LEOFF 1 medical account would each be 6% of pay.

Were the funding status of LEOFF 1 to change and contributions again required, members and employers would each contribute the statutorily required 6% of pay, and no contributions would go to the medical account.

MEMBERS IMPACTED:

There is no impact on member pension benefits or contributions. The 1,147 active members would be impacted by having to make contributions to a medical account when the required member contribution rate to the pension plan is less than 6%.

When the market value of LEOFF 1 assets are projected using actual investment returns through 8/30/03 and an assumed 8% rate of return thereafter, the plan remains in a surplus position until the 9/30/2009 valuation date. An unfunded liability would then emerge once unrecognized prior asset losses are fully reflected in the projected actuarial value of assets. Under this scenario, members would contribute 6% of pay to the medical account from 7/1/2004 through 6/30/2011: \$3.1, \$2.5, \$2.0, \$1.6, \$1.2, \$0.9 and \$0.7 million for a total of \$12 million over the period. Employers would contribute the same amount to the medical account. After 7/1/2011, 6% employee and employer contributions are projected to resume for the pension plan.

FISCAL IMPACT:

There is no impact on the pension plan.

State Actuary's Comments:

There are very limited opportunities to prefund medical benefits under a tax-qualified trust. It is unclear whether this proposed program would qualify under current federal tax law.



RECEIVED

MAY 21 2004

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Washington State Senate

Senator Bob Morton
7th Legislative District

**Office of
The State Actuary
District Office:**
3278 Pierre Lake Road
Kettle Falls, WA 99141
Phone: (509) 684-5132

May 19, 2004

Dear Members of the Select Committee on Pension Policy:

During this past session, I was contacted by a former constituent, Sandra White, who is in dire financial circumstances because of the application of a survivor benefit statute. I would like to request that the Select Committee on Pension Policy ("SCPP") consider legislation that would remedy Ms. White's unfortunate plight.

Enclosed is Ms. White's correspondence, and following is a summary of her issue in the hope that the SCPP will find this useful in its consideration of this matter:

Issue

Ms. White was married to a LEOFF 1 member for 41 years. They divorced in 2000, some four years after he retired. The court order entitled her to half of his retirement benefit. Mr. White died one month after the divorce, thereby terminating Ms. White's retirement allowance. As a homemaker for all the years of their marriage, Ms. White has little money now.

2002 Legislative Change: Survivor Benefit for Ex-Spouses of LEOFF 1 Members

In the 2002 session, the legislature passed ESB 6380 which, among other things, granted a survivor benefit to ex-spouses of LEOFF 1 members, provided certain criteria were met.

The criteria included: (a) the member must have had 30 years of service, (b) the parties must have been married at least 25 years, and (c) the parties must have entered into a court-approved property settlement agreement awarding a portion of the member's benefits to the ex-spouse after June 13, 2002.

Under the bill as passed, Ms. White did not qualify for a survivor benefit. Her husband had 29 years & 10 months of service, not 30 years. And the court order entitling her to half of his retirement was entered in 2000, not after June 13, 2002.

Options to Solve Ms. White's Situation

There are several ways in which Ms. White's situation could be remedied and a survivor benefit could be obtained. Most notably, SB 6380 as it passed the Senate in 2002 would have solved Ms. White's problem, as it did not have the thirty year member requirement nor the time restriction on when the court order was entered into. Had that version not been subsequently amended, Ms. White would be receiving benefits now. I would ask the committee to consider this, or another alternative, as a solution to Ms. White's problem.

Thank you for your consideration.

Cordially yours,

A handwritten signature in black ink that reads "Bob".

BOB MORTON
State Senator

Enclosure

cc: Matthew Smith ✓

**Retired Firefighters of Washington**

15310 163rd Ct. SE
Renton, WA 98058-8122
425-226-3793
rffow@attbi.com

Richard Warbrouck
President

Bob Burtch
Secretary

October 5, 2004

The Honorable Karen Fraser
Chair, Select Committee on Pension Policy
PO Box 40422
Olympia, WA 98504-0422

Dear Senator Fraser,

I would like to draw your attention to a letter I forwarded to Senator Winsley dated January 12, 2004 regarding RCW 41.26.110.(B).

Senator Winsley was kind enough to introduce SB 6355 in the 2004 session and Representative Helen Sommers introduced HB 3114 in the House. The two bills were intended to correct the existing language and create a new provision to allow two law enforcement officers to serve on a county disability board when there are no firefighters eligible to serve. RCW 41.26.110 (B) states "Each county shall establish a disability board having jurisdiction over all members residing in the county." This is incorrect. The members don't have to reside in the county. They have to be employed by an employer within the county.

RCW 41.26.110 (B) presently states "An active or retired firefighter or law enforcement officer to be eligible to serve on the board must be employed by or retired from the county." This is incorrect. Any active or retired firefighter or law enforcement officer who is employed or was previously employed by an employer or agency under the jurisdiction of the board is eligible to serve. Only those active and retired LEOFF 1 firefighters and law enforcement officers who are under the jurisdiction of the board are eligible to vote in disability board elections.

We also want to correct a new problem. Island County for example, has no LEOFF 1 active or retired firefighters under the jurisdiction of the board so they have no active or retired firefighters members eligible to elect a representative to the board. This eliminates the fire representative on the board, thereby reducing the number of board members by one creating an imbalance on the board. Our bill will allow the law enforcement officers to elect a second law enforcement officer representative to the board in these situations.

Both bills were passed out of their assigned committee and sent to the Rules Committee in each chamber. They were up for Second Reading but failed to get voted out of Rules by the cut-off. I respectfully request that the Select Committee consider these two bills and include them in the committee's legislative package.

I have also included a letter dated May 17, 2004 addressed to Senator Winsley, Chair, Select Committee on Pension Policy in where I requested to have SB 6355 and HB 3114 placed on the Select Committee's interim agenda.

I also referred to the statement by Matt Smith, the State Actuary, at the April 20, 2004 meeting that the LEOFF 1 Fund could have an unfunded liability as early as 2008. If this is correct I would request the Committee to reinstate the LEOFF 1 contributions. I would question the wisdom of continuing the present contribution holiday. To continue the contribution holiday would only create an escalating problem for a future legislature.

Due to the fluctuating value of the LEOFF 1 Fund, I would suggest that the Office of the State Actuary give a complete report to the Committee regarding the LEOFF 1 Fund. The LEOFF 1 Fund members would like, for once, to understand the value, the liability, the assumption and the computations used in determining these values.

If there is a surplus of \$757,000.00, as previously reported, I would like the Committee to evaluate the need for the actuarially reduced pension for the new Survivor Benefit as created in ESB 6380.

I request that the Committee consider extending the new Survivor Benefit option as created in ESB 6380 to those members who are only receiving a partial pension. Currently, any member who is receiving less than a full pension due to a personal property settlement in a divorce decree is not eligible to select this option. Those members who would become eligible would of course have their reduced pensions further reduced by the same percentage as those members who are receiving a full pension and exercised this option. The benefit would be based on the member's current pension and paid for by the actuarial reduction.

Thank you for your consideration.

Sincerely,

Richard C. Warbrouck

**Retired Firefighters of Washington**

15310 163rd Ct. SE
Renton, WA 98056-8122
425-226-3793
rffow@attbl.com

Richard Warbrouck
President

Bob Burch
Secretary

January 12, 2004

Senator Shirley Winsley
1109 Garden Circle
Fircrest, WA 98466-6218

Dear Senator Winsley,

I want to remind you of the current discrepancies in RCW 41.26.110 (B), LEOFF 1 City and County Disability Boards and want to request your assistance in making some housekeeping amendments to RCW 41.26.110. RCW 41.26.110 (B) states that "Each county shall establish a disability board having jurisdiction over all members residing in the county." This is incorrect. The members don't have to reside in the county. They have to be employed by an employer within the county.

RCW 41.26.110 (B) presently states that "An active or retired firefighter or law enforcement officer to be eligible to serve on the board must be employed by or retired from the county." This is incorrect. Any active or retired firefighter or law enforcement officer who is employed by an employer or agency under the jurisdiction of the board is eligible to serve. Only those active and retired LEOFF 1 firefighters and law enforcement officers who are under the jurisdiction of the board are eligible to vote in these disability board elections.

I have attached a copy of an e-mail from Jan L. Ford, the Secretary of the Island County Disability Board. Jan explains that the Island County Board has no LEOFF 1 active or retired firefighters under the jurisdiction of the board so they have no active or retired firefighter members eligible to elect a representative to the board. This eliminates the fire representative on the board, thereby reducing the number of board members by one which creates an imbalance on the board. I suggested in a letter to the Select Committee on Public Pensions that in these situations the law enforcement officers should elect a second law enforcement officer representative to the board.

Representative Steve Conway, Chair of the Select Pension Committee, informed me that the Select Committee did not have the time to advertise and schedule a Public Hearing regarding this issue and suggested that I have a bill introduced. I did discuss this with Eric Sund as you suggested. Eric was very helpful in assisting me with the Code Reviser.

The emergency designation would be appropriate on this amendment because as of December 31, 2003 the firefighter representative is no longer eligible to serve on the board.

I will contact your office to be advised of your decision and to ascertain if you are in need of any additional information.

Thank you for your consideration.

Respectfully,

Richard C. Warbrouck

[Print Message](#) | [Close](#)

From : "LEOFF1.Net" <gtaylor@leoff1.net>
To : "Jan Ford" <JanF@co.island.wa.us>
Cc : "Richard Warbrouck" <rmwarbrouck@juno.com>
Subject : RE: SB 5090
Date : Sat, 18 Oct 2003 14:40:19 -0700

1 360 679-7353

Jan,

I don't know if I got back to you on this as I have been out of town on vacation.

This was a screw up in the legislature. Everybody is aware of the problem but nothing can be done to fix it until the legislature resumes.

You might contact Dick Warbrouck, the President of the Retired Fire Fighters of Washington. I know he is tracking this issue. His email address is: mwarbrouck@juno.com

Terry Taylor
taylor@leoff1.net

-----Original Message-----

From: Jan Ford [mailto:JanF@co.island.wa.us]
Sent: Monday, September 22, 2003 3:34 PM
To: gtaylor@leoff1.net
Subject: SB 5090

Hello: I am the secretary to the Island County LEOFF I Disability Board. Very recently we learned of the effect of SB 5090 passed by the 2003 legislature that changed RCW41.26.110 affecting who can vote for representatives on the local disability boards. The passage of this legislation has effectively eliminated our fire fighter representative position on our board as we have no LEOFF I fire fighters in Island County, and therefore, no one to vote.

Are you familiar with the background of this legislation? Have you heard from other counties/boards in the same position?

Thanks..

Jan L. Ford

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Island County Commissioners Office

P. O. Box 5000, Coupeville, WA 98239

Phone: (360) 679-7353

**Retired Firefighters of Washington**

15310 163rd Ct. SE
Renton, WA 98058-8122
425-226-3703
rflow@attbl.com

Richard Warbrouck
President

Bob Burch
Secretary

May 17, 2004

The Honorable Shirley Winsley
Chair, Select Committee on Pension Policy
PO Box 40428
Olympia, WA 98504-0428

The Honorable Steve Conway
Vice Chair, Select Committee on Pension Policy
PO Box 40600
Olympia, WA 98504-0600

Mr. Matthew Smith, State Actuary
Office of the State Actuary
PO Box 40814
Olympia, WA 98504-0914

Dear Senator Winsley, Representative Conway and Mr. Smith:

I forwarded a letter and addressed the Committee at the April 20, 2004 meeting requesting that SB 6355 and HB 314, the Companion Bill be placed on the agenda for consideration. I also request that the Committee evaluate the comment made by the State Actuary at the April 20th meeting regarding the LEOFF 1 Fund. He suggested that the fund may develop an unfounded liability as early as 2008 or 2011. If he is correct, I would question the wisdom of continuing the present contribution holiday. To continue, the contribution holiday would only create an escalating problem for a future legislature.

During the 2004 interim I am requesting that the Office of the State Actuary give a complete report to the Committee regarding the LEOFF 1 Fund. The members would like, for once, to understand the value, the liability, the assumptions and the computations used in determining these values.

In addition, we are requesting that the following issues be placed on the agenda for the 2004 interim meetings. Some of these issues have been mentioned in the past, however they are very important to the members and worthy of a complete analysis.

- Establishing a medical fund. This would reduce the liability to the employers for the payment of medical expenses. We would establish a 6% contribution for the

member and for the employer. This contribution would not be associated with the former pension contributions, so as not to violate any IRS rules.

- **Survivor Benefit:**

- A) To evaluate the need for the actuarially reduced pension for the new survivor benefit for LEOFF 1 members.
- B) Extending the new survivor benefit option to those members who are only receiving a partial pension. This option is not available to these members at the present time.

This would not require a fiscal note as the benefit would be based on the current pension and paid for by an actuarial reduction.

Your assistance in placing these issues on the agenda would certainly be appreciated.

Sincerely,



Richard C. Warbrouck

PFC Audit and Recommendations

Background

The Select Committee on Pension Policy (SCPP) is required to study and make recommendations on changes to assumptions or contribution rates to the Pension Funding Council (PFC) prior to adoption of changes by the PFC.

Committee Activity

Presentations:

August 17, 2004 - Full Committee
September 7, 2004 - Full Committee

Subgroup Activity:

August 31, 2002 - PFC Subgroup

Recommendation to Legislature

None. At the September 7, 2004, the SCPP recommended that the PFC adopt the 2005-07 contribution rates, as calculated by the State Actuary, including the cost of recognizing the liability associated with future gain-sharing benefits.

Staff Contact

Matthew M. Smith, State Actuary
(360) 753-9144 – smith.matt@leg.wa.gov

Select Committee on Pension Policy

Pension Funding Council Audit and Recommendations

(August 9, 2004)

Issue

The Select Committee on Pension Policy (SCPP) is required to study and make recommendations on changes to assumptions or contribution rates to the Pension Funding Council (PFC) prior to adoption of changes by the PFC.

Staff

Matt Smith, State Actuary
360-753-9144

Council Membership

The PFC consists of the following members:

- Director of the Department of Retirement Systems;
- Director of the Office of Financial Management;
- Chair and ranking minority member of the house of representatives appropriations committee; and
- Chair and ranking minority member of the senate ways and means committee.

The PFC is supported by a work group consisting of one staff member from each of the following agencies or committees: Department of Retirement Systems, Office of Financial Management, State Investment Board, Senate Ways and Means Committee, House Appropriations Committee, and the Economic and Revenue Forecast Council.

Power and Duties

The PFC adopts changes to long-term economic assumptions, asset smoothing method and contribution rates. The council solicits and administers a biennial actuarial audit of the actuarial valuations used for rate-setting purposes and administers an actuarial audit of the results of the experience study required under RCW 41.45.090.

Any changes adopted by the PFC are subject to revision by the legislature.

Coordination with SCPP

Upon receipt of the results of the actuarial audits, the PFC submits the results to the SCPP. The SCPP studies and makes recommendations on changes to assumptions or contribution rates to the PFC prior to adoption of changes under RCW 41.45.030 (adoption of long-term economic assumptions), 41.45.035 (long-term economic assumptions and asset smoothing technique), or 41.45.060 (adoption of contribution rates).

Process Overview and Time Line

Beginning April 1, 2004, and every four years thereafter:

- the state actuary submits to the PFC information regarding the experience and financial condition of the state retirement systems (report attached).

By May 31, 2004, and every four years thereafter:

- the PFC may adopt changes to the long-term economic assumptions and asset smoothing technique (no changes were adopted in 2004).

By August 31, 2004, and every two years thereafter:

- the PFC receives the preliminary results of the actuarial audits and submits the results to the SCPP.

Not later than September 30, 2004, and every two years thereafter:

- the SCPP studies and makes recommendations to the PFC on changes to assumptions or contribution rates.
- the PFC adopts and may make changes to the basic employer and state contribution rates for PERS, TRS, SERS, LEOFF Plan 1 and WSP. The contribution rates are effective for the ensuing biennium subject to revision by the legislature.

2004 SCPP Action Items

- Receive the preliminary results of the actuarial audits (by August 31, 2004)
- Study and make recommendations to the PFC on changes to contribution rates (prior to adoption by the PFC in September).

The PFC did not adopt changes to the long-term economic assumptions or asset smoothing method. The statutory deadline to adopt such changes for this year's cycle was May 31, 2004. Therefore, the available period for the SCPP to provide recommendations to the PFC on assumptions and asset smoothing method has closed. The next statutory window for this review opens on April 1, 2008 and closes on May 31, 2008.

Preliminary Contribution Rates

System	Current Employer Rates	Preliminary Employer Rates for 05-07*
PERS	1.18%	5.49%
TRS	1.17%	6.51%
SERS	0.85%	7.27%
LEOFF 1	0.00%	0.00%
WSP	0.00%	4.35%

Excludes current administrative expense charge of 0.22%

** Unaudited results. Includes the cost of prefunding the liability for existing gain-sharing benefit provisions in PERS, TRS and SERS.*

System	Current Plan 2 Employee Rates	Preliminary Plan 2 Employee Rates for 05-07*
PERS	1.18%	3.25%
TRS	0.87%	2.48%
SERS	0.85%	3.51%
WSP (all actives)	2.00%	4.35%

The employee contribution rate in PERS and TRS Plan 1 is fixed at 6%. Plan 3 employees do not contribute to the defined benefit portion of their plan.

** Unaudited results.*

Select Committee on Pension Policy

PFC Subgroup Report

(September 3, 2004)

The PFC subgroup of the SCPP met in Olympia, Washington on August 31, 2004.

Subgroup members attending:

Senator Fraser
Representative Conway
Representative Fromhold
Leland Goeke
Glenn Olson
J. Pat Thompson

Meeting Summary

Representative Conway called the meeting to order and discussed the purpose of the subgroup meeting was to formulate a recommendation to the full SCPP concerning the adoption of employer and plan 2 member contribution rates for the 2005-07 biennium. Matt Smith, State Actuary, reviewed SCPP and PFC background materials related to the subgroup's agenda.

The subgroup discussed the preliminary 2005-07 contribution rates presented by the State Actuary and reviewed the preliminary actuarial audit report presented to the PFC by Milliman U.S.A. on August 31, 2004. The report found that the actuarial work performed by the Office of the State Actuary (OSA) was reasonable and appropriate, the total liabilities calculated by Milliman matched closely to the liabilities calculated by the OSA, and the resulting contribution rates calculated by the OSA for the 2005-07 biennium are accurate.

The subgroup discussed the impact of funding the liability for future gain-sharing benefits. As reported by the State Actuary and verified in the actuarial audit, future gain-sharing benefits represent a material liability to the affected retirement systems and were excluded from previous actuarial valuations

performed by the OSA. Subgroup members that attended the earlier PFC meeting discussed that the Office of Financial Management (OFM) was not aware of the fiscal impact of recognizing the liability of future gain-sharing benefits and that the additional \$176 million GF-S impact was not included in preliminary OFM budget documents for the 2005-07 biennium.

The subgroup then discussed a proposal presented by Member Olson to defer or phase-in projected rate increases over a 6-year period. Representative Conway proposed that a deferred rate increase proposal could be combined with a permanent contribution rate floor. The subgroup members directed the State Actuary to prepare a deferred rate increase proposal for the September 7, 2004 Executive Committee meeting of the SCPP.

Subgroup Recommendations

Recommendation to the PFC

Adopt the preliminary 2005-07 contribution rates, as calculated by the State Actuary, including the cost of recognizing the liability associated with future gain-sharing benefits.

Recommendation to the SCPP

Develop a legislative proposal that would defer or phase-in projected employer and plan 2 member rate increases over the next 3 biennia. Proposal should include a permanent contribution rate floor after the 6-year phase-in period is completed.

Select Committee on Pension Policy

P.O. Box 40914
Olympia, WA 98504-0914
actuary_st@leg.wa.gov

September 10, 2004

Mr. John F. Charles, Chair, Pension Funding Council (PFC)
P.O. Box 48380
Olympia, Washington 98504-8380

Dear Mr. Charles:

RE: SCPP RECOMMENDATION TO THE PFC

As required under RCW 41.04.281(4), the Select Committee on Pension Policy (SCPP) received and studied the results of the preliminary actuarial audit report dated August 31, 2004 and recommends that the Pension Funding Council adopt the preliminary 2005-07 contribution rates, as calculated by the State Actuary, including the cost of recognizing the liability associated with future gain-sharing benefits.

The SCPP supports the continued full funding of the Washington State retirement systems, but also realizes the significant financial commitment associated with implementing required contribution rate increases, in the short term, may present a financial hardship for retirement system employers and Plan 2 members. In response, the SCPP is discussing a legislative proposal that would phase-in required employer and Plan 2 member contribution rate increases over a 6-year period; followed by a permanent contribution rate floor thereafter.

Sincerely,



Senator Karen Fraser, Chair



Representative Steve Conway, Vice Chair

cc SCPP members
PFC members
PFC work group

N:\SCPP\9-04 SCPP Recommendation to PFC.wpd

Representative Gary Alexander

Elaine M. Banks
TRS Retirees

Marty Brown, Director*
Office of Financial Management

Senator Don Carlson

John Charles, Director
Department of Retirement Systems

Representative Steve Conway*
Vice Chair

Richard Ford
PERS Retirees

Senator Karen Fraser*
Chair

Representative Bill Fromhold

Leland A. Goeke*
TRS and SERS Employers

Bob Keller
PERS Actives

Corky Mattingly
PERS Employers

Doug Miller
PERS Employers

Glenn Olson
PERS Employers

Representative Larry Crouse

Diane Rae
TRS Actives

Senator Debbie Regala

J. Pat Thompson
PERS Actives

David Westberg*
SERS Actives

*Executive Committee

(360) 753-9144
Fax: (360) 586-8135
TDD: 1-800-635-9993

Purchasing Power

Background

Purchasing power in relation to retirement is the measure of how a benefit retains its value over time. The concern among PERS 1 and TRS 1 retirees is that because of inflation, their benefits may be losing purchasing power, particularly for those who have been retired for extended periods. The Select Committee on Pension Policy considered Purchasing Power to be among their four top priority issues to discuss during the 2004 interim.

Committee Activity

Presentations:

July 13, 2004 - Full Committee
August 17, 2004 - Full Committee

Subgroup Activity:

September 7, 2004 - Subgroup Meeting
October 19, 2004 - Subgroup Meeting
November 9, 2004 - Subgroup Meeting

Recommendation to Legislature

See “Plan 1 COLA/Gain-sharing” tab.

Staff Contact

Robert Wm. Baker, Senior Research Analyst
(360) 586-9237 – baker.robert@leg.wa.gov

Select Committee on Pension Policy

Purchasing Power

(December 15, 2004)

Issue

Purchasing power in relation to retirement is the measure of how a benefit retains its value over time. The concern among retirees is that because of inflation, their benefits may be losing purchasing power, particularly for those who have been retired for extended periods. The Select Committee on Pension Policy considered Purchasing Power to be among their four top priority issues to discuss during this interim.

Staff

Robert Wm. Baker, Senior Research Analyst
360-586-9237

Members Impacted

This issue primarily impacts Public Employees' Retirement System plan 1 (PERS 1) and Teachers' Retirement System plan 1 (TRS 1) members. As of the most recent valuation, there were 21,737 active and 54,006 retired PES 1 members, and 12,456 active and 33,148 retired TRS 1 members.

Current Situation

Currently, the purchasing power of PERS 1 and TRS 1 benefits is partially protected by the Uniform Increase they receive on July 1st of each year after one year of retirement and after age 66. The Uniform increase is a dollar amount multiplied by the members' total years of service; that product is added to a member's monthly benefit each year. As of July 1, 2004, the Uniform Increase Amount was \$1.21; a retiree who was at least age 66 with 30 years of service will be receiving a monthly increase of \$36.30.

The Uniform Increase Amount increases each year by at least 3%. When gain-sharing is available, distributions are made by enhancing the Uniform Increase amount and thus the Uniform COLA.

Also available to PERS 1 and TRS 1 members is the COLA payment option. Upon retirement, members may choose to take an actuarially adjusted benefit that increases each year with inflation to a maximum of 3% per year—similar to the Plan 2 COLA. This option became available in 1990, and gives members greater financial stability during retirement.

History

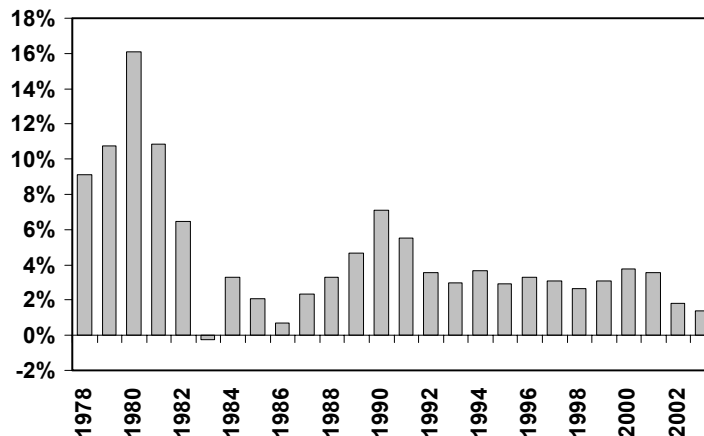
The PERS 1 and TRS 1 plans have experienced numerous legislative efforts to provide some level of purchasing power protection. The history of those efforts can be found in Appendix A of this report. These efforts began in 1961 with the establishment of a \$900/year minimum pension for those who retired at age 70 with at least 10 years of service. The most recent efforts lead to the \$1,000/ month Minimum Benefit legislation passed this year.

Less successful efforts to bolster TRS 1 and PERS 1 retiree's purchasing power have included bills seeking to increase the frequency of gain-sharing or lower the investment return threshold for determining when gain-sharing distributions occur. Gain-sharing, established in 1998, occurs on even-numbered years when the compounded rate of return on the TRS and PERS plan assets exceeds 10% over the most recent 4-year period. One-half of the amount in excess of 10% is distributed to TRS 1 and PERS 1 retirees via the Uniform COLA and to Plan 3 member's through their defined contribution accounts.

The legislative history of efforts to shore-up TRS 1 and PERS 1 retiree's purchasing power is a history of inflation; inflation being the reason retirement benefits lose purchasing power in the first place. Inflation is treated as a constant in the plan designs and within the actuarial valuations, which is appropriate considering the long-term character of retirement systems. For

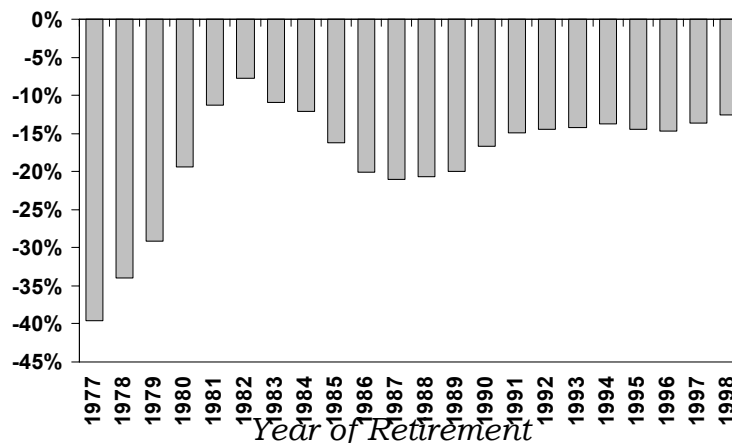
individuals, however, inflation is a variable that can change from year to year (see Figure 1). In the past 25 years, local changes in consumer prices have been as high as 16.1% and as low as -0.3%.

Figure 1
Annual Percent Changes
Seattle CPI-W: 1978-2003



Because of the variability of inflation, for those retirees whose benefit is not protected by a COLA, *when* they retire has a bearing on how their benefit retains its purchasing power. A worker who retired in 1977 would have seen their benefit lose almost 40% in value in the first five years of retirement (see Figure 2).

Figure 2
Purchasing Power Loss In the
First 5 Years of Retirement



Examples

Purchasing power is measured by comparing the change in member's benefits over time with the amount of inflation over the same period. In these examples, the Consumer Price Index for Wage Earners and Clerical Workers (CPI-W) for the Seattle-Tacoma-Bremerton region has been used for the inflation measure. Also used in this calculation are benefits members originally received upon retirement and benefits they currently receive (see Figure 3).

Figure 3 Purchasing Power Calculation

$(\text{Current Benefit} / \text{Original Benefit}) \times (\text{Original CPI-W} / \text{Current CPI-W})$

Current Benefit : \$1,164
Original Benefit : \$1,002
Original CPI-W : 369.0
Current CPI-W : 553.6
 $(\$1,164 / \$1,002) \times (369.0 / 553.6)$
 $116.2\% \times 66.7\% = 77.43\%$

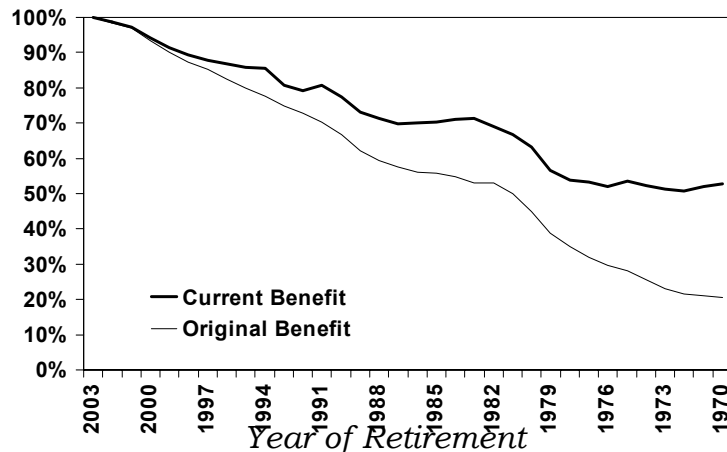
The above illustration uses the average benefit data from PERS 1 members who retired in 1990. By 2003, their average benefits had increased 16.2%. Inflation over the same period, as measured by the CPI-W, had increased by 50%. To determine the benefit's purchasing power, they must be deflated by a factor of .667. As a result, the current benefits have retained 77.4% of their original purchasing power.

This method was used to measure the purchasing power for all PERS and TRS members who retired from 1970 onward.

Plan 1 Examples

Figure 4 (following page) demonstrates the experience of PERS 1 members who have retired since 1970. The gap between the Original Benefit line and the Current Benefit line represents the COLAs that members have received.

Figure 4
Purchasing Power of PERS 1
Service Benefits in 2003

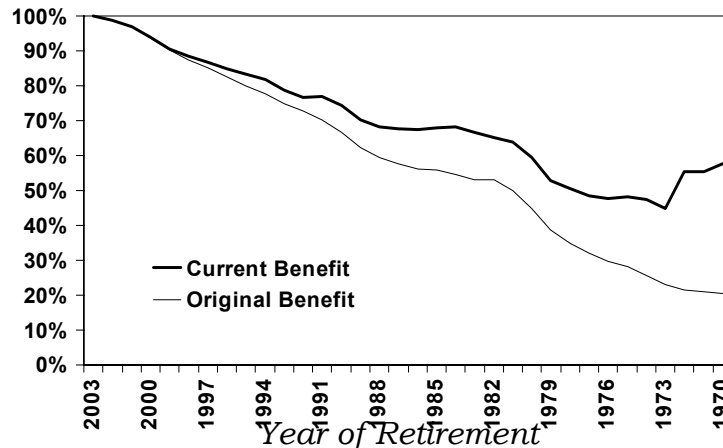


The varying slopes of the lines represent the changes in inflation with the steepest slopes being the periods of highest inflation. What this example illustrates is the relatively short time it takes for a PERS 1 benefit to lose a significant amount of value. Those who retired in 1999 have already lost 10% of their original benefit's purchasing power. At the most extreme point on this graph member benefits have experienced a loss of almost 50% of their original purchasing power.

Also evident in this graph is the potential loss of purchasing power if there had been no COLAs whatsoever. Had a member retired in 1970 and received no benefit improvements, their 2003 benefit would be worth but 20% of its original purchasing power.

The TRS 1 illustration (see Figure 5) is similar except for some obvious bump-up of benefits for those retired the longest. Early legislation that sought to improve retiree benefits tended to be system specific; TRS retirees benefitted from these COLAs. In addition, those retirees whose retirement allowance had lost the most are those who receive the greatest improvement from the current Uniform increases, this was particularly evident for those TRS 1 members who retired in 1970-1972 under the 1% plus annuity formula.

Figure 5
Purchasing Power of TRS 1
Service Benefits in 2003



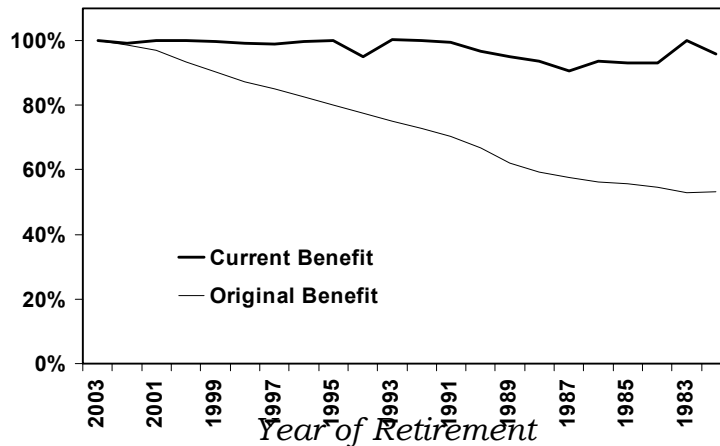
Because TRS members retire an average of 1.5 years younger than PERS members (58.5 years compared to 60 years), the decline in purchasing power is a bit more pronounced early in their retirement because they must wait longer to receive the Uniform COLA. Similar to PERS retirees though, those retired the longest have experienced a loss of about half their original purchasing power.

Plan 2/3 Examples

Purchasing power trends in the plans 2/3 offer a telling contrast to PERS 1 and TRS 1. Retired plan 2/3 members receive a CPI-based COLA beginning one year after retirement (the plan 3 COLA covers the defined benefit). In addition, plan 2/3 members receive the COLA even when they opt for early retirement.

A similar COLA is a payment option for PERS 1 and TRS 1 retirees. By taking the COLA payment option, members accept an actuarially reduced initial benefit in order to receive CPI-based COLAs (to a maximum of 3% per year.) This provides plan 1 members a more stable benefit stream.

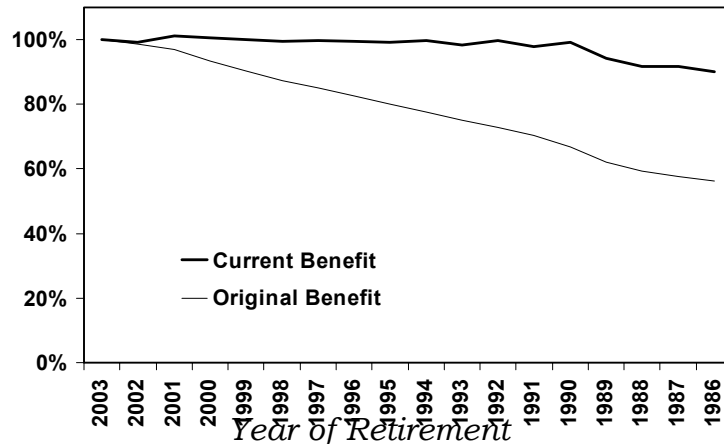
Figure 6
Purchasing Power of PERS 2/3
Service Benefits in 2003



PERS 2/3 purchasing power patterns are distinctive in their stability. Even after twenty-one years of retirement, member's benefits lost only 5% of their original purchasing power (see Figure 6). And that loss may not be permanent; COLA design in the plans 2/3 allows benefits to "catch-up" during low-inflation years. In comparison, after twenty-one years, PERS 1 member's benefits had lost 31% of their original purchasing power.

TRS 2/3 purchasing power patterns differ from those of PERS 2/3 only in that the first TRS 2 retirements were in 1986 while the first PERS 2 retirements were in 1982.

Figure 7
Purchasing Power of TRS 2/3
Service Benefits in 2003



TRS 2/3 benefits have retained their purchasing power similar to those of PERS 2/3. After seventeen years of retirement the average TRS 2/3 benefit retained 90% of its purchasing power (see Figure 7). This is a bit different than the PERS 2/3 benefit in that inflation in eight of the last seventeen years was above 3%. More recently it has been below 3%, meaning that those TRS 2/3 members who retired in 1986-1989 may experience some COLA catch-up over the next several years. Nonetheless, the benefit design allows members to retain a significant level of their original purchasing power over extended periods.

Policy Analysis

The means to protect retiree benefits from loss of purchasing power is by cost-of-living-adjustments (COLAs). The original design of TRS 1 and PERS 1 did not include an automatic COLA. This was not necessarily an oversight in the plan, which was established in 1947, but was more likely because few retirement plans had automatic COLAs at that time; even Social Security benefits were not inflation indexed until 1975. Because of the absence of an original automatic COLA, the lost purchasing power of TRS 1 and PERS 1 benefits has been addressed by frequent ad hoc efforts and sometimes complex legislation for those whose benefits had lost significant purchasing power.

The need for an automatic COLA was acknowledged in the design of the Plans 2 and 3, which include a CPI-based COLA that begins one year after retirement, including early retirement. The policy decision driving that design was that "...retiree benefits should have some form and degree of protection from inflation." In recognition of the cost of such a benefit, plan 2 design also incorporated an age-based retirement requirement (age 65 with at least 5 years of service) and did not include the service-based retirement criteria of plan 1 (30 years of service at any age).

Policy Constraints

The retirement policy that may constrain any benefit improvements in PERS 1 and TRS 1 seeks to "... fund benefit increases for plan members over the working lives of those members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service." This policy is based on the concept of inter-generational equity. As the plan 1s have been closed since 1977, as there are now more retirees than active members, and as the employee contribution rate is fixed in statute, the source of contributions to fund any improvement becomes, more and more, taxpayers who never received services from these members.

Fiscal Constraints

Because of the significant losses of purchasing power, the cost of any remedy would be similarly significant. Were it decided that PERS 1 and TRS 1 retiree allowances should not fall below 60% of their original purchasing power, then the allowances of 4,800 PERS and 3,700 TRS service retiree's would need to be adjusted. In the first year alone, the cost would be almost \$13 million dollars.

Figure 8
First Year Cost to Fund Minimum
Levels of Purchasing Power
For PERS 1 and TRS 1 Service Retirees (\$millions)

	Level of Original Purchasing Power		
	60%	70%	80%
PERS 1	\$4.9	\$14.5	\$43.7
TRS 1	\$8.0	\$21.4	\$50.7
Total	\$12.9	\$35.9	\$94.4

Demographic Issues

Demographic trends play a tangential role in purchasing power analysis. As retirees continue to live longer, the more inflation can erode their retirement benefits. PERS 1 members tend to retire at 60 years of age and TRS 1 members at 58.5 years of age. So on average, PERS retirees will go about 6 years before receiving their first Uniform COLA and TRS retirees will go 7½ years. On top of that, according to the most recent life-expectancy tables, a PERS female retiring today at age 60 can expect to live another 24 years (see Figure 9). The average TRS female retiring today can expect to live another 27.1 years.

Figure 9
Life Expectancy at Average
Retirement Age

	Male	Female
PERS (age 60)	21.4	24.0
TRS (age 58½)	24.5	27.1

Comparisons with other Washington Systems/Plans

There are three post-retirement COLA designs in Washington's retirement systems: the fully indexed benefit for Law Enforcement Officers and Fire Fighter's (LEOFF) plan 1 retirees, the CPI-based 3% capped COLA for plan 2/3 retirees, and the Uniform Increase for TRS 1 and PERS 1 retirees.

The monthly retirement benefit for a member of the Law Enforcement Officer's and Fire Fighter's plan 1 is fully indexed to the CPI-W for the Seattle-Tacoma-Bremerton region. On April 1 of each year, beginning one year after retirement, the members' benefits are adjusted based on the annual percent increase in the CPI as measured over the previous calendar year.

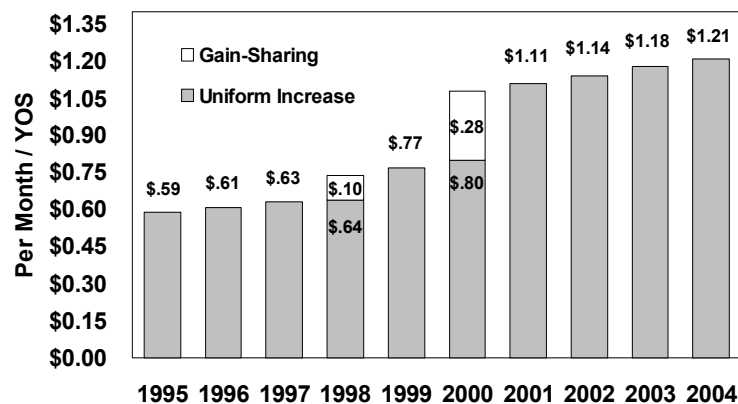
The monthly retirement benefit for a member of the plan 2s, and the defined benefit portion of the plan 3s, is indexed to the CPI-W for the Seattle-Tacoma-Bremerton region to a maximum of 3% per year. On July 1 of each year, beginning one year after retirement, the members' benefits are adjusted based on the annual percent increase in the CPI as measured over the retiree's entire period of retirement.

Monthly retirement benefits for PERS 1 and TRS 1 members are adjusted by what is known as the Uniform COLA. The Uniform COLA is the product of the Uniform Increase Amount multiplied by each retirees years of service (yos). The Uniform Increase Amount grows at 3% per year and is also enhanced by gain-sharing (see Figure 10).

Figure 10

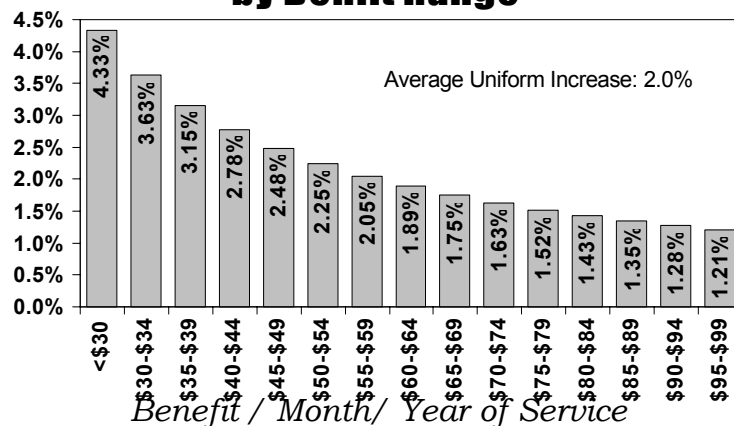
PERS 1 & TRS 1

Uniform Increase Amount



Unlike the aforementioned COLAs that apply the same percent increase to each member's benefit, the Uniform increase is based solely on years of service. As a result, a retiree with 30 years of service and a low benefit will receive the same dollar adjustment as a retiree with 30 years of service and a high benefit. This rewards low benefit retirees with greater purchasing power protection than high benefit retirees (see Figure 11).

Figure 11
Uniform COLA Percent Increase
by Benefit Range



The ability of the Plan 1 Uniform COLA to protect retiree's purchasing power after age 66 is illustrated in the following Figures. The "illustrations" assume the member retires at various ages with a \$1,500/month benefit. The benefit value is deflated by the actual changes in Seattle area consumer prices as measured by the CPI-W. The member begins receiving the annual Uniform increases in 1995 when reaching age 66 (birthday prior to July 1.)

Figure 12 illustrates the deflated benefit stream of a member retiring at age 55 in 1984. At age 55 the member will have to wait 11 years before receiving their first COLA. Based on the changes in consumer prices over that period, the benefit would have declined to about \$1,059 in current value by 1995 (see Figure 12). Upon receipt of the Uniform COLA the benefit would stabilize, and by 2004 it would have retained much of its 1995 value. If not for the COLA, the benefit would have been worth just over half its original value by 2004.

Figure 12
Plan 1 Purchasing Power
For a Member Retiring at Age 55

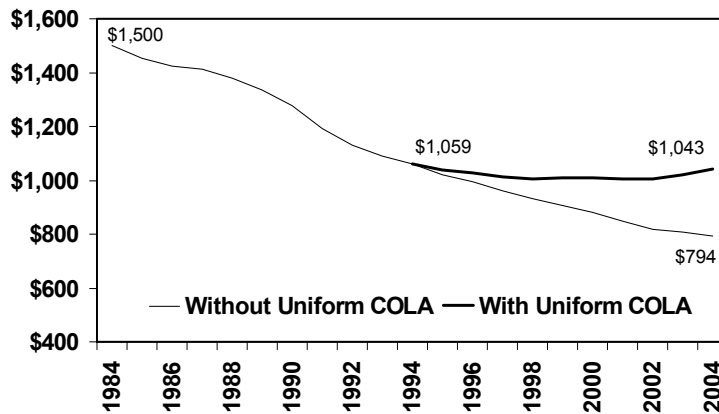
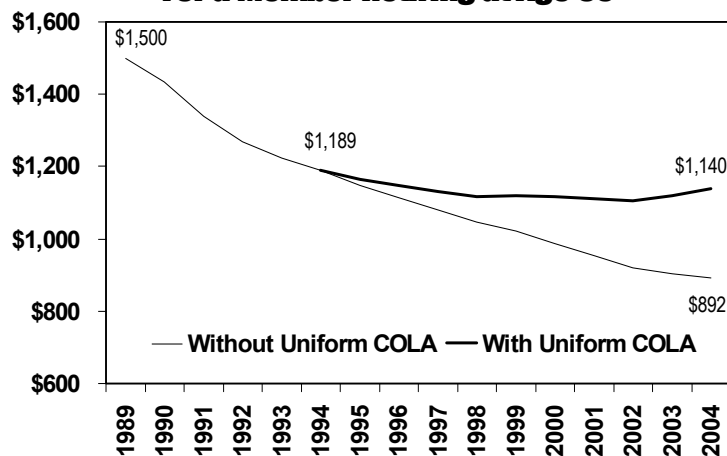


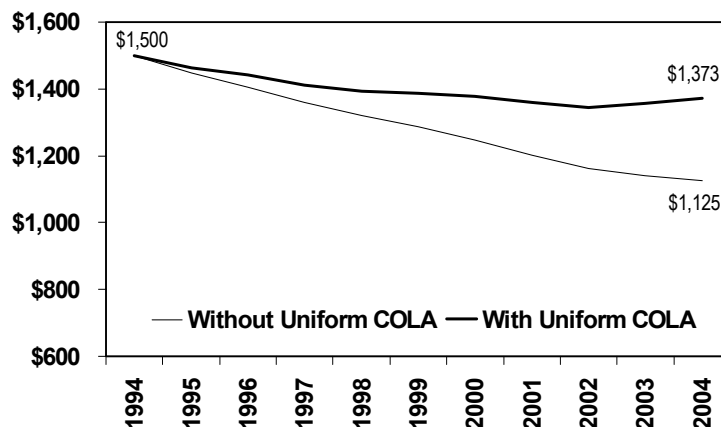
Figure 13
Plan 1 Purchasing Power
For a Member Retiring at Age 60



In Figure 13 the member's benefit loses about 20% of its original purchasing power before eligibility to receive the Uniform Increase. Even after receiving the Uniform Increase, the benefit still loses value until 2002 when it begins to recover, inching back to 76% of its original purchasing power by 2004. Were it not for the Uniform increase, the benefit would have continued to lose purchasing power, declining to less than 60% of its original value by 2004.

A member who retired at age 65 in 1994 would have an entirely different experience. By not having to wait an extended period before being eligible for the Uniform COLA, their benefit loses considerably less purchasing power (see Figure 14). By 2004, this member's benefit would be over \$250 per month above where it would have been without the COLA.

Figure 14
Plan 1 Purchasing Power
For a member Retiring at Age 65



Comparisons with Other State and City Plans

Among the eleven systems chosen to provide a standard comparison, all provide some form of COLA (see Figure 15). Five of those systems provide COLAs that are CPI based with varying caps, the highest being 6%, the lowest being 2%. The remaining systems provide percent increases that range from a low of 1.5% to a high of 3.5%. Most begin after 1 year of retirement; Florida and Idaho provide prorated COLAs for those retired less than one year.

Figure 15
COLA Provisions by Select Retirement Systems

System	COLA
Cal PERS	2% (80% purchasing power min.)
Cal STRS	2% simple (80% purchasing power min.)
Colorado PERA*	3.5%
Florida (FRS)	3%
Idaho (PERSI)	CPI based, 1% min, 6% max,

System	COLA
Iowa (IPERS)	Simple increase: 3% max
Minnesota (MSRS)	CPI based, 2.5% max + investment surplus
Missouri (MOSERS)*	80% of change in the CPI, 5% max
Ohio (OPERS)*	CPI based, 3% max
Oregon PERS*	CPI based, 2% max
Seattle (SCERS)	1.5% (60% purchasing power min.)

Several of the comparison systems provide protection against specific losses of purchasing power. Benefits in the California systems cannot fall below 80% of the original benefit's purchasing power. Benefits in the Seattle system cannot fall below 60% of their original purchasing power. This is similar to a 1992 COLA provision that protected PERS 1 and TRS 1 members from the loss of 40% of their age 65 benefit's purchasing power.

Human Resource Impact

The absence of a COLA for TRS 1 and PERS 1 members who retire before age 65 may have an impact on public sector human resource policies in Washington State. The post-retirement employment issue is driven by numerous factors, one of which may include a member's fear of losing the purchasing power of their benefit. Returning to work after retiring is a reasonable choice for those hoping to accrue additional assets to help cover future inflation and other fast-growing expenses.

The loss of a retirement benefit's purchasing power tends to be a gradual process. But even modest amounts of inflation can have significant long-term effects. Recognition of this phenomena resulted in the COLA provisions in the plan 2/3 designs, and also the most recent efforts to provide some systematic benefit protections in PERS 1 and TRS 1. The Uniform Increase provides some protection over inflation -- a phenomenon totally outside the member's control. Members may also choose the Optional COLA payment upon retirement, which gives them greater control and benefit stability.

As PERS 1 and TRS 1 are closed plans with more annuitants than active members, additional COLA improvements would be more difficult to provide under existing funding policy.

Funding: Ad Hoc vs. Permanent

There are differing funding mechanisms if a benefit increase is ad hoc or permanent. An ad hoc benefit is a one-time increase that must be funded in the year in which it is given [RCW 41.45.070(5)] – akin to pay-as-you-go. In general, benefit increases to inactive members would tend to be ad hoc – active members would not tend to be effectively eligible for whatever benefit had been granted. A permanent benefit increase tends to be prospective, though not exclusively, with all active members, and sometimes retirees, receiving the benefit; and employer contribution rates will increase to pay for the benefit. Because of the funding method in PERS 1 and TRS 1, permanent benefit increases are rolled into each plan's unfunded actuarially accrued liability (UAAL) – this is similar to an individual taking out a second mortgage – and funded through the amortization date (June 30, 2024).

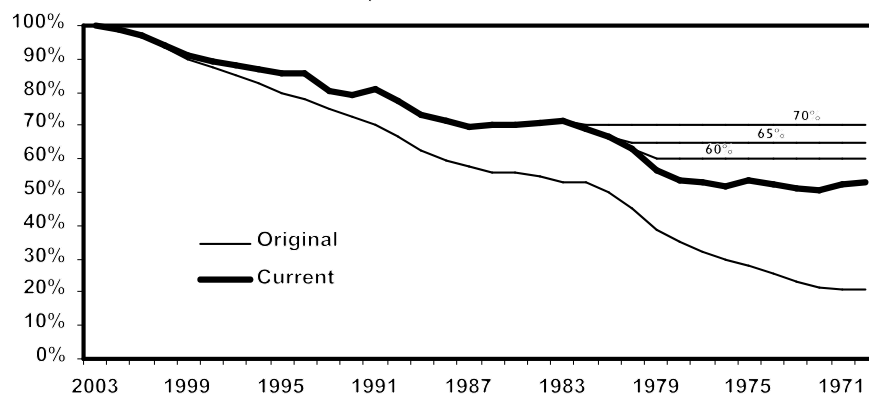
Options to Recover and Maintain Purchasing Power

These options fall into two broad groups -- those that will result in recovery of lost purchasing power, and those that will maintain purchasing power. Options 1-4 would allow those who have been retired for extended periods recover a portion of their lost purchasing power. Though all retirees will eventually receive the Uniform COLA, only those with long service and relatively small allowances are able to recover some of their lost purchasing power through receipt of the Uniform COLA. Options 5-9 are more conceptual in nature; they would allow current and future retirees to maintain their purchasing power. While many retirees are at least able to maintain their purchasing power from the point at which they became eligible for the Uniform COLA, the loss of purchasing power prior to receipt of the COLA is normally quite substantial for those who retire prior to age 60.

Option 1: Establish a permanent minimum purchasing power floor under which retirees could not fall. Several comparative systems – CalPERS, CalSTRS, Seattle City Employees Retirement System – use these kinds of provisions. That floor could be set at 60%, 65%, or 70% of the original benefit's purchasing power (see Figure 1). Because these purchasing power losses are based on the timing of a member's retirement, the effect would be to boost the allowance of those retired prior to a specific date. For instance, PERS members whose benefit is less than 60% of its original purchasing power retired prior to 1980; this is about 9,400

retirees. TRS members whose benefit is currently less than 60% of its original purchasing power retired prior to 1981; about 6,300 retirees.

Figure 1
Purchasing Power of PERS 1 Benefits with 60%,
65%, and 70% Floors



This would initially appear to be an ad hoc benefit -- a one-time bump-up with future allowances protected by the Uniform COLA. However, for retirees with less than 20 years of service, the Uniform COLA may not keep up with projected inflation. As a result, the funding would need to be permanent. This option would have a significant actuarial cost and a high administrative impact for the Department of Retirement Systems (the Department).

While the Uniform COLA provides some degree of protection from inflation, as per existing retirement system policy, this option would enhance that policy to set a minimum purchasing power floor. The 60% floor would also increase the current unfunded liability by \$1,720 million. Any retroactive benefit increase may be in conflict with the policy to fund benefits over members' working lives.

Estimated Fiscal Impact of Establishing a Benefit Purchasing Power Floor

	% of Original Purchasing Power					
	60%		65%		70%	
(\$ in millions)	PERS	TRS	PERS	TRS	PERS	TRS
Increase in Unfunded Actuarial Accrued Liability (UAAL)	\$980	\$740	\$1,390	\$1,060	\$1,880	\$1,460
Increase in Employer Contribution Rate	0.70%	1.31%	0.99%	1.88%	1.35%	2.58%
General Fund						
1 st Biennium	\$31.2	\$80.0	\$44.1	\$114.7	\$60.2	\$157.4
25 Year	\$555.0	\$1,388.0	\$786.0	\$1,992.3	\$1071.1	\$2,733.6
Non-General Fund						
1 st Biennium	\$35.1	\$0.0	\$49.7	\$0.0	\$67.9	\$0.0
25 Year	\$612.5	\$0.0	\$866.4	\$0.0	\$1181.6	\$0.0
Local Government						
1 st Biennium	\$58.9	\$16.3	\$83.2	\$23.5	\$113.6	\$32.2
25 Year	\$1,035.3	\$284.1	\$1,464.6	\$407.5	\$1,997.9	\$559.6

Option 2: Enhance the Uniform COLA by boosting the Annual Increase Amount to provide greater purchasing power protection for recent retirees and recovery of purchasing power for earlier retirees. The Annual Increase Amount is currently \$1.21; each July 1, it increases by 3% plus any gain-sharing distributions. One proposal was to increase it to \$1.50 or \$2.00. Because the Annual Increase Amount goes up each year and would eventually reach those levels, this proposal provides a permanent early increase for eligible retirees. This option would have an actuarial cost and a low administrative impact for the Department.

While the Uniform COLA provides some degree of protection from inflation, as per existing retirement system policy, this option would still be in accordance with that policy and simply provide an early increase in the Uniform COLA amount. It would also increase the current unfunded liability by \$200 million. This would be a retroactive benefit increase and may be in conflict with the policy to fund benefits over members' working lives.

Estimated Fiscal Impact of Increasing the Annual Increase Amount by 10¢			
(\$ in millions)	PERS	TRS	TOTAL
Increase in Unfunded Actuarial Accrued Liability (UAAL)	\$110	\$90	\$200
Increase in Employer Contribution Rate	0.08%	0.17%	
General Fund			
1 st Biennium	\$3.6	\$10.3	\$13.9
25 Year	\$63.2	\$180.0	\$243.2
Non-General Fund			
1 st Biennium	\$4.0	\$0.0	\$4.0
25 Year	\$69.7	\$0.0	\$69.7
Local Government			
1 st Biennium	\$6.6	\$2.0	\$8.6
25 Year	\$117.9	\$36.3	\$154.2

Option 3: Increase the yearly multiplier for the Annual Increase Amount.

Currently the Annual Increase Amount increases by at least 3% per year. Since the actuarial inflation assumption is 3.5% per year, the multiplier for the Annual Increase Amount could be raised to 3.5% per year or higher (see Figure 2). Changing the adjustment factor would provide greater purchasing power protection for long service, low benefit retirees. This option would have a modest actuarial cost and a low administrative impact on the Department.

Figure 2
Yearly Multiplier for the Annual Increase Amount and Monthly Benefit for a Retiree with 20 Years of Service

		2004	2005	2006	2007	2008	2009	2010	2011
3.0%	Amount	\$1.21	\$1.25	\$1.29	\$1.33	\$1.37	\$1.41	\$1.45	\$1.49
	Benefit	\$24.20	\$25.00	\$25.80	\$26.60	\$27.40	\$28.20	\$29.00	\$29.80
3.5%	Amount	\$1.21	\$1.25	\$1.30	\$1.34	\$1.39	\$1.44	\$1.49	\$1.54
	Benefit	\$24.20	\$25.00	\$26.00	\$26.80	\$27.80	\$28.80	\$29.80	\$30.80
4.0%	Amount	\$1.21	\$1.26	\$1.31	\$1.36	\$1.42	\$1.47	\$1.53	\$1.59
	Benefit	\$24.20	\$25.20	\$26.20	\$27.20	\$28.40	\$29.40	\$30.60	\$31.80

While the Uniform COLA provides some degree of protection from inflation, as per existing retirement system policy, this option would still be in accordance with that policy and simply align the adjustment to the Annual Increase Amount with the current actuarial inflation assumption. The 3.5% multiplier would also increase the current unfunded liability by \$150 million. As this would be a retroactive benefit increase it may be in conflict with the policy to fund benefits over members' working lives.

Estimated Fiscal Impact of Increasing the Multiplier for the Annual Increase Amount				
	3.5%		4.0%	
(\$ in millions)	PERS	TRS	PERS	TRS
Increase in Unfunded Actuarial Accrued Liability (UAAL)	\$80	\$70	\$170	\$150
Increase in Employer Contribution Rate	0.06%	0.13%	0.12%	0.26%
General Fund				
1 st Biennium	\$2.6	\$8.0	\$5.3	\$15.9
25 Year	\$47.2	\$137.8	\$94.6	\$275.4
Non-General Fund				
1 st Biennium	\$3.0	\$0.0	\$5.9	\$0.0
25 Year	\$52.4	\$0.0	\$105.0	\$0.0
Local Government				
1 st Biennium	\$5.0	\$1.6	\$10.1	\$3.4
25 Year	\$88.0	\$28.0	\$177.2	\$56.2

Option 4: Increase the \$1,000 alternative minimum benefit by 3% per year. This would change an ad hoc benefit into a permanent benefit. The current minimum benefit is \$32.97 per month per year of service, and it increases each year by the Annual Increase Amount. At the latest, the minimum benefit will reach \$41.07 in 2010, thus surpassing the \$1,000 alternative minimum for a member with 25 years of service. By increasing the \$1,000 alternative minimum benefit by 3% per year, eligible retirees will be more able to retain that level of purchasing power. This option would have a modest actuarial cost and a low administrative impact on the Department.

While the Alternative Minimum Benefit provides some degree of protection from inflation, as per existing retirement system policy, this option would still be in accordance with that policy and simply change it from an ad hoc benefit to a permanent benefit. It would also increase the current unfunded liability by \$11 million. Any retroactive benefit increase may be in conflict with the policy to fund benefits over members' working lives.

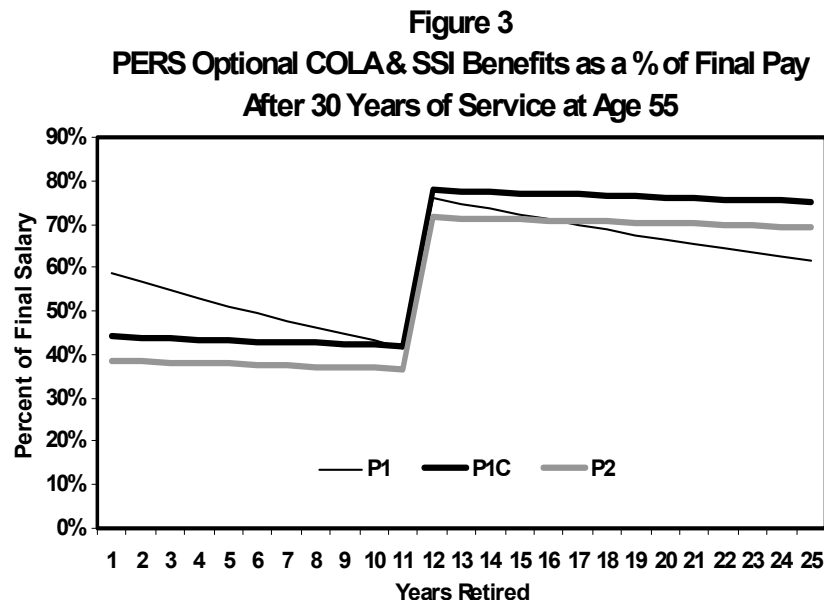
Estimated Fiscal Impact of Making the \$1,000 Minimum a Permanent Benefit that Increases by 3% per Year			
(\$ in millions)	PERS	TRS	TOTAL
Increase in Unfunded Actuarial Accrued Liability (UAAL)	\$7	\$4	\$11
Increase in Employer Contribution Rate	0.01%	0.01%	
General Fund			
1 st Biennium	\$0.4	\$0.5	\$0.9
25 Year	\$7.7	\$10.5	\$18.2
Non-General Fund			
1 st Biennium	\$0.5	\$0.0	\$0.5
25 Year	\$8.7	\$0.0	\$8.7
Local Government			
1 st Biennium	\$0.8	\$0.1	\$0.9
25 Year	\$14.5	\$2.1	\$16.6

Summary of Proposals to Recover Purchasing Power: Options 1 through 4		
(\$ in millions)	1st Biennium Cost	Administrative Impact
Title		
1. 60% Benefit Floor	\$221.5	High
1. 65% Benefit Floor	\$315.2	High
1. 70% Benefit Floor	\$431.3	High
2. Annual Increase Amount to 10¢	\$26.5	Low
3. Annual Increase Multiplier to 3.5%	\$20.2	Low
3. Annual Increase Multiplier by 4.0%	\$40.6	Low
4. Increase \$1,000 minimum 3% per year	\$2.3	Low

Maintaining Purchasing Power

The following proposals to maintain purchasing power are more conceptual than the first four. It is apparent that the recovery of lost purchasing power is costly. It may, therefore, be appropriate to engage in preventative measures so that future retirees are not subject to extended periods where they receive no inflation adjustment to their retirement benefit.

Option 5: Make the current Plan 1 COLA Payment Option the default during retirement calculations and the option would then be to refuse the COLA. At the same time, provide PERS 1 and TRS 1 members a higher level of education on the ramifications of opting out of the COLA; use of illustrations like Figure 3 to explain the advantages of the COLA option may result in greater utilization. This option would have no actuarial impact, but would have a medium administrative impact for the Department.

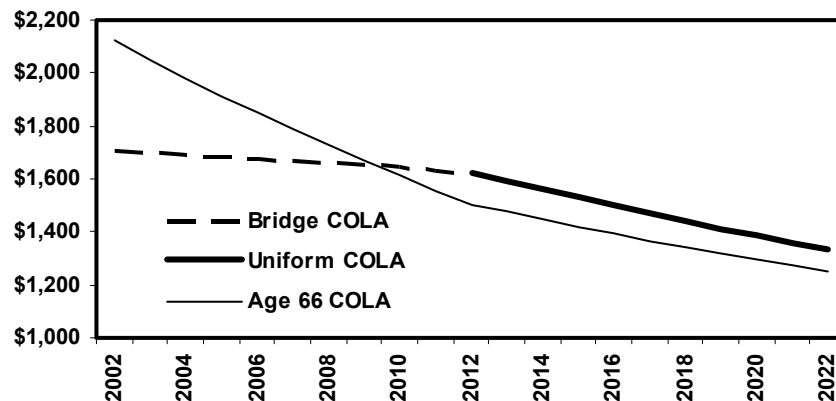


It is unlikely that this provision would be in conflict with existing retirement policies as it neither changes nor diminishes members' benefits.

Option 6: Offer a "Bridge COLA" for those PERS 1 and TRS 1 members retiring before age 65 that sunsets when members become eligible for the Uniform COLA. A member could choose an actuarially equivalent 1.5%, 2.0%, or 3% optional COLA payment

for however many years until the member becomes Uniform COLA eligible (see Figure 4). This option would have no actuarial impact, but would have a high administrative impact for the Department.

Figure 4
PERS 1 Benefit at Age 55
With Bridge COLA and Uniform COLA



While the Uniform COLA provides some degree of protection from inflation, as per existing retirement system policy, this option would still be in accordance with that policy and allow further purchasing power protection for those retiring several years before being eligible for the Uniform COLA.

Option 7: Modify the Plan 1 COLA Payment Option. The benefit of PERS 1 and TRS 1 members who chose the 3% COLA payment option upon retirement is actuarially reduced. Allow members to choose a 2% or 1.5% COLA payment option. The actuarial factors vary by age – younger retirees experience a greater reduction; the initial benefit of an age 55 retiree is reduced by about 25% should they choose the 3% COLA option. By offering a 1.5% COLA option, for example, the reduction in the initial benefit would be about half the reduction of the 3% COLA option, (see Figures 5 and 6). This option would have no actuarial impact, but would have a high administrative impact for the Department.

Figure 5
PERS 1 Actuarial Factors for
Various COLA Payment Options at Select
Retirement Ages

	COLA Payment Options		
	3.0%	2.0%	1.5%
Age 55	0.7510	0.8310	0.8722
Age 60	0.7731	0.8462	0.8837
Age 65	0.7972	0.8627	0.8963

Figure 6
Adjusted PERS Benefits at Select Ages
by COLA Payment Options: Average Benefit = \$2122

	COLA Payment Options		
	3.0%	2.0%	1.5%
Age 55	\$1,594	\$1,763	\$1,851
Age 60	\$1,641	\$1,796	\$1,875
Age 65	\$1,692	\$1,831	\$1,902

Option 8: Modify the Plan 1 COLA Payment Option. The benefit of PERS 1 and TRS 1 members who chose the COLA payment option upon retirement is actuarially reduced. By trading off the cost of the Uniform COLA, which includes gain-sharing, the actuarial impact for the 3% COLA payment option can be reduced. Because the Uniform COLA is based on service rather than average final compensation (AFC), it is of more value to members with long service and low benefits. As a result, the changes in actuarial factors would be based on both the member's service and AFC. This option would have no actuarial impact, but would have a medium administrative impact for the Department.

Option 9: Subsidize the Plan 1 COLA Payment Option. The benefit of PERS 1 and TRS 1 members who chose the COLA payment option upon retirement is actuarially reduced. As a result, those choosing this option pay for their own COLA. By providing an employer subsidy cost-sharing can be introduced, and the actuarial impact for the 3% COLA payment option can be reduced. This option would have an actuarial impact and a medium administrative impact for the Department.

Multiple Options

In order to respond to both the Purchasing Power issue and Adequacy of Benefits issue, and to simultaneously recover and maintain purchasing power, several of these options could be melded into one. This could be done, for example, by establishing the purchasing power floor below which retirees would not fall, and redesigning the PERS 1 and TRS 1 COLA provisions. In this manner, existing retiree purchasing power issues would be addressed and future retiree COLA issues would be eased. While the Uniform COLA and Annual Increase Amount are considered non-contractual, any revision to a material benefit must be undertaken with caution. In addition, the IRS recently released its latest Minimum Distribution regulations which have an impact on public sector COLAs, and any such modifications would likely need Tax Council review.

APPENDIX A**History of Post-Retirement Adjustments in TRS 1 and PERS 1**

Date	TRS 1	PERS 1
3/21/61 (SERS)		Minimum pension \$900/year if retired at age 70 with 10 or more years of service \$60/month if 15-19 years of service \$70/month if 20-24 years of service \$80/month if 25-29 years of service \$90/month if 30 or more years of service
3/21/67		Minimum benefit increases to: \$60/month if 12-15 years of service \$90/month if 16-19 years of service \$120/month if 20 or more years of service
7/1/67	Pension portion of benefit increased to \$5.50/month/year of service if age 65 and not qualified for Social Security	
3/25/69		Minimum benefit increases to: \$75/month if 12-15 years of service \$100/month if 16-19 years of service \$130/month if 20 or more years of service
7/1/70	Minimum benefit revised to \$5.50/month/year of service. Applicable to members retiring before 4/1/69. Applied to the pension portion of the benefit.	The following received for each \$1 of pension by year of retirement: '49 - \$1.5239 '56 - \$1.3687 '63 - \$1.2116 '50 - \$1.5386 '57 - \$1.3485 '64 - \$1.1960 '51 - \$1.5239 '58 - \$1.3031 '65 - \$1.1813 '52 - \$1.4110 '59 - \$1.2601 '64 - \$1.1620 '53 - \$1.3805 '60 - \$1.2501 '65 - \$1.1291 '54 - \$1.3702 '61 - \$1.2116 '66 - \$1.0980 '55 - \$1.3643 '62 - \$1.2255 '67 - \$1.0536
7/1/77		5.95% COLA applied to pension portion of the benefit if retired before 12/31/70.
7/1/72	5.9% COLA for all members retired before 7/1/71, plus an additional 5.4% for those retired between 7/1/69 and 6/30/70.	
4/25/73		Minimum benefit of \$6.50/month/year of service. 3% permanent increase based on assets in excess of current liabilities.
7/1/73	\$3/month/year of service for retirees not eligible for Social Security.	Increase of 1.0609% if the member retired before 1972 and their service retirement allowance was adjusted in section (1) for adjustment made of 4/25/73.

History of Post-Retirement Adjustments in TRS 1 and PERS 1 (cont)

Date	TRS 1	PERS 1
7/1/74	11.9% pension increase for those retired on 6/31/70. 2.9% pension increase for those retired 7/1/70 - 6/30/73. 3% COLA on total allowance for those retired on 12/31/73.	3% COLA for those retired prior to 12/31/73
7/1/75		3% COLA for those retired prior to 12/31/74
7/1/76	Minimum pension benefit of \$7.50/month/year of service if retired prior to 4/25/73.	3% COLA for those retired prior to 12/31/75
7/1/77	Minimum pension benefit of \$8.00/month/year of service if retired prior to 4/25/73.	3% COLA for those retired prior to 12/31/76
7/1/78		3% COLA for those retired prior to 12/31/77
7/1/79	Minimum pension benefit of \$10/month/year of service for retirees of 7/1/79. Disability and survivor benefits as of 12/31/78, and service benefits as of 7/1/74 permanently increased by \$0.8171 multiplied by the member's years of service.	Minimum pension benefit of \$10/month/year of service for retirees of 7/1/79. 3% COLA for those retired prior to 12/31/78.
7/1/80		3% COLA for those retired prior to 12/31/79.
7/1/81		Excess earnings adjustment no longer in effect as employer contribution rate increased above rate of 4/24/73.
7/1/83	\$0.74/month/year of service COLA to disability and survivor benefits being received on 12/31/82 and service retirement benefits being received on 7/1/78.	
7/1/86	Minimum benefit increased to \$13.00/month/year of service	
7/1/87	Permanent automatic 3% annual increase to the minimum benefit becomes effective. Minimum pension benefit increased to \$13.50/month/year of service.	
7/1/88	Minimum pension benefit increased to \$13.82/month/year of service.	
7/1/89	Minimum pension benefit increased by \$1 to \$14.91/month/year of service and then increased 3% to \$15.36/month/year of service. Permanent automatic COLA enacted for retirees whose age 65 purchasing power had been reduced by more than 40%.	
7/1/90	Minimum pension benefit increased 3% to \$15.72/month/year of service. 3% COLA for eligible retirees.	
7/1/91	Minimum pension benefit increased 3% to \$16.19/month/year of service. 3% COLA for eligible retirees.	
2/1/92	The current benefits of those eligible for the COLA adjusted to be equal to 60% of their age 65 retirement allowance.	
7/1/92	Minimum pension benefit increased 3% to \$16.68/month/year of service. 3% COLA for eligible retirees.	

History of Post-Retirement Adjustments in TRS 1 and PERS 1 (cont)

Date	TRS 1	PERS 1
7/1/93	<p>Minimum pension benefit increased 3% to \$17.18/month/year of service. 3% COLA for eligible retirees. Continuation of special adjustment effective 2/92. Temporary ad hoc COLA effective through 6/30/94, \$3/month/year of service for those retired 5 years, who were 70 years of age, and did not receive a COLA in 1992.</p>	
7/1/94	<p>Minimum pension benefit increased 3% to \$17.70/month/year of service. 3% COLA for eligible retirees. Special adjustment effective 2/92 made permanent. Temporary ad hoc COLA extended to 6/30/95. Provides \$3/month/year of service to eligible retirees.</p>	
7/1/95	<p>Uniform Increase established. Initial increase of \$0.59/month/year of service to be increased by 3% per year. Retirees are eligible for the Uniform Increase if they have been retired at least one year and are age 66 by July 1st in the calendar year in which the annual increase is given, or if their retirement allowance is lower than the minimum benefit amount.. Minimum benefit increased to \$24.22/month/year of service, and to automatically increase each year by the Annual Increase amount. Temporary ad hoc COLA that had been extended to 6/30/95 made permanent.</p>	
7/1/98	<p>Gain-sharing established, providing even-year enhancements to the Annual Increase amount based on half the compound average investment returns in TRS 1 and PERS 1 plan assets over the previous four fiscal years that exceed 10%.</p>	
7/1/04	<p>\$1,000 minimum benefit (before optional benefit payments) established for retirees with 25 years of service and at least 20 years of retirement. Does not include an automatic increase. Effectively sunsets after the regular minimum increases to \$40/month/year of service.</p>	

Retiree Health Insurance

Background

Health insurance has become one of the most significant expenses retirees face, particularly those who leave employment before Medicare eligibility. Because the cost of health insurance continues to rise faster than the average change in consumer prices, it absorbs an ever-greater share of retirees' income, and can diminish the adequacy of their remaining retirement benefits.

This paper covers the current provisions related to retiree health insurance as it relates to members of State-administered retirement systems and plans. It also discusses the nationwide trends in health care costs and how those costs have a greater impact on the elderly population. And to conclude, it discusses the measures of health care inflation and which of those measures most closely reflects the experience of retirees.

Committee Activity

Presentation:

September 7, 2004 - Full Committee

Recommendation to Legislature

None.

Staff Contact

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Select Committee on Pension Policy

Retiree Health Insurance

(August 31, 2004)

Issue

Health insurance has become one of the most significant expenses retirees face, particularly those who leave employment before Medicare eligibility. Because the cost of health insurance continues to rise faster than the average change in consumer prices, it absorbs an ever-greater share of retirees' income, and can diminish the adequacy of their remaining retirement benefits. This paper will cover the current provisions related to retiree health insurance as it relates to members of State-administered retirement systems and plans. It will also discuss the nationwide trends in health care costs and how those costs have a greater impact on the elderly population. And to conclude, it will discuss the measures of health care inflation and which of those measures most closely reflects the experience of retirees.

Staff

Robert Wm. Baker, Senior Research Analyst
360-596-9237

Members Impacted

Members of all systems and plans except the Law Enforcement Officer's and Fire Fighters retirement system plan 1 whose members receive full health care coverage in retirement.

Current Situation

Currently, retired or disabled state employees, retired or disabled school employees, retired or disabled higher-education employees, or employees of county, municipal, or other political subdivisions who are retired may continue their participation in employer provided insurance plans and contracts after retirement or disablement. Separated employees may continue their participation if it is selected immediately upon separation from employment.

Surviving spouses and dependent children of emergency service personnel killed in the line of duty may also participate in insurance plans and contracts.

Premiums charged to retired or disabled employees, separated employees, spouses, surviving spouses of emergency service personnel killed in the line of duty, or dependent children who are not yet eligible for Medicare parts A and B are based on the experience of the community rated risk pool. The risk pool is comprised of employees of school districts and educational service districts, state employees, retired or disabled school employees not yet eligible for Medicare parts A and B, and state retirees not yet eligible for Medicare parts A and B. These premiums are *implicitly subsidized*, meaning that the large risk pool that includes active members lowers the premium for the retirees or inactive members.

Premiums charged to those who are eligible for Medicare parts A and B are calculated from their own experience risk pool. This premium is *explicitly subsidized*. Beginning with the 1995-97 budget, the legislature established a portion of the state, school district, and educational service district allocation to be used to provide a subsidy to reduce the health care insurance premiums charged to those retirees eligible for Medicare parts A and B. The amount of the premium reduction is established by the Public Employee's Benefits Board (PEBB), and cannot result in a premium reduction of over 50%. The current retiree premiums can be found in the PEBB pamphlet following this report.

According to the House and Senate Fiscal committee staff, in the 2003-05 biennium the state will pay close to \$223 million dollars to subsidize health care insurance for 37,000 Medicare eligible and 10,800 non-Medicare eligible retirees. The estimated cost is evenly split between the implicit and the explicit subsidies.

History

The Health Care Authority (HCA) was established in 1988 (Ch. 107) to replace the State Employees' Insurance Board. In concert, the State Employee Benefits Board was established within the Health Care Authority to design and approve insurance benefit plans for state employees and retirees. The scope of the State Employees' Benefits Board has since been broadened to include employees and retirees of county, municipal, or other political subdivisions hence it has been named the Public Employees' Benefits Board (PEBB).

Recent Legislation

In 2002, the Legislature passed Substitute House Bill (SHB) 2536 (Ch. 142 L of 02) giving school districts that purchase PEBB coverage the ability to participate in the composite rating structure offered to state agencies. The bill required districts joining PEBB on or after September 1, 2002, to pay the entire composite rate charged by the HCA. SHB 2536 also required the school districts to charge their employees the same contributions as state employees.

In 2003, the Legislature passed Substitute Senate Bill (SSB) 5236 (Ch. 158 L of 03), which clarifies the way the HCA collects health care premiums from school districts. This bill affects those districts currently participating in the PEBB program as well as districts requesting participation in the future. The bill requires the HCA to collect the entire premium (composite + employee premium) from the district. However, it allows the employee portion of the PEBB premium to be determined at the district level, as long as the employee pays at least as much as a state employee. SSB 5236 became effective September 1, 2003.

Several bills were introduced in 2003 that did not pass the legislature. HB 1424 sought to create a statutory method for establishing the subsidies for retiree's health care premiums. HB 1425 attempted to open the enrollment in PEBB insurance programs to all TRS, PERS, and SERS retirees and their dependents. This would have allowed retirees who did not take advantage of the initial 60 day enrollment period, to enroll during an annual window. Neither of these bills received a hearing.

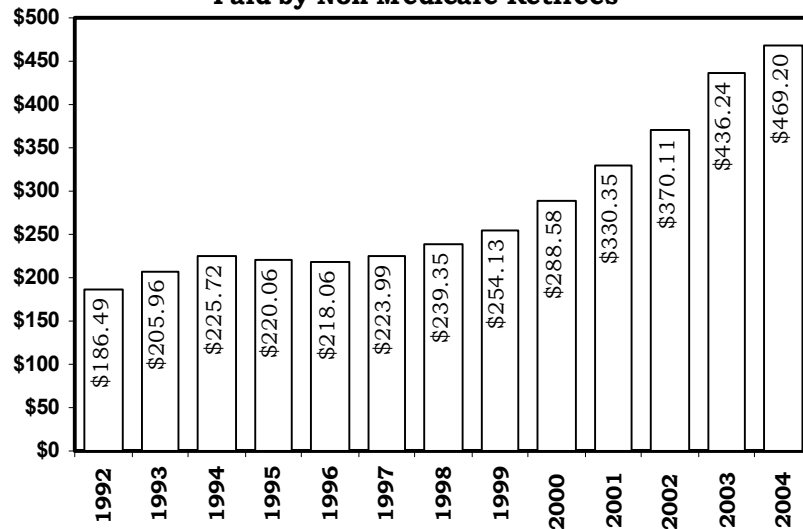
SB 5525 attempted to open the enrollment in PEBB insurance plans for separated (terminated-vested) plan 2 members who were at least age 55 and had 10 years of service. Plan 3 members are afforded this option. Plan 2 members currently must be receiving a retirement allowance to be eligible. This bill did not pass out of committee.

In 2004, HB 3192 attempted to create health savings account options for employees that conformed to section 223, Part VII of subchapter B of chapter 1 of the internal revenue code of 1986. The bill did not receive a hearing.

Retiree Premiums

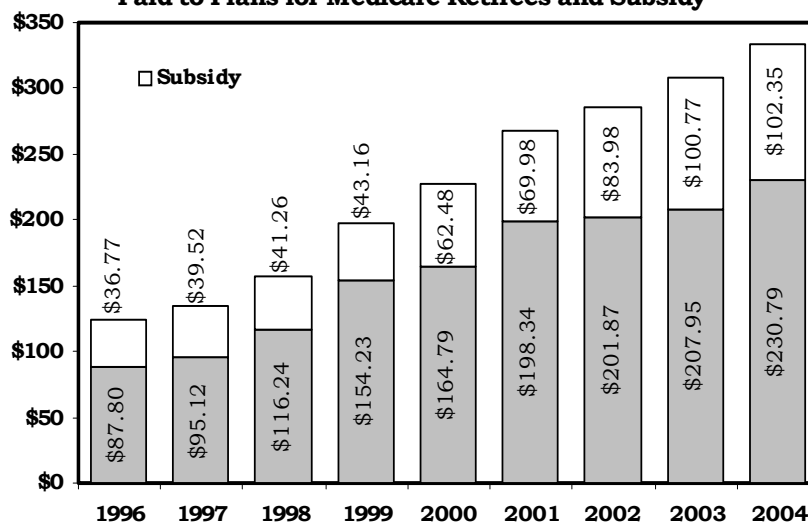
As noted previously, retirees may purchase health insurance by paying the same premiums as are paid by their employers. Over the last ten years, retirees have paid premiums that have changed varying amounts from year to year. Some years they changed a modest amount, and some years, like 2004, they changed a great deal. The weighted average of the PEBB premiums paid by non-Medicare retirees from 1992 to 2004 is illustrated in Figure 1. The average premium increased by over 150% in this period, and most of that increase has occurred in the last 5 years.

Figure 1
Average Monthly PEBB Premium
Paid by Non-Medicare Retirees



The costs borne by Medicare-eligible retirees (age 65 and over) are typically about half that of non-Medicare retirees (see Figure 2). But even with the explicit subsidy, monthly premiums have increased at a 13% annual pace over the past 8 years. The subsidy to support Medicare-eligible PEBB retirees has kept up with these increases.

Figure 2
Average monthly PEBB Premium
Paid to Plans for Medicare Retirees and Subsidy



The most recent premiums for 2004 vary from as little as \$125 per month for a single subscriber who is already enrolled in Medicare parts A and B, to over \$1,000 per month for a full family not yet eligible for Medicare (see Figure 3 and PEBB pamphlet for premiums by specific plan).

<i>Figure 3</i>		
Monthly PEBB Retiree Rates		
<i>Effective July 1, 2004</i>		
Subscribers not eligible for Medicare or enrolled in Part A only	Lowest	Highest
Subscriber Only	\$322.84	\$374.71
Subscriber & Spouse	\$641.84	\$745.58
Subscriber & Child(ren)	\$562.09	\$652.86
Full Family	\$881.09	\$1,023.73
2		
Subscribers enrolled in Parts A & B of Medicare		
Subscriber Only	\$125.92	\$241.34
Subscriber & Spouse (1 eligible)	\$423.41	\$612.21
Subscriber & Spouse (2 eligible)	\$203.48	\$478.84
Subscriber & Child(ren)	\$345.36	\$519.49
Subscriber & Child(ren) (2 eligible)	\$203.48	\$478.84
Full Family (1 eligible)	\$667.63	\$890.36
Full Family (2 eligible)	\$445.18	\$756.99
Full Family (3 eligible)	\$303.30	\$716.34
Dental Plans with Medical Plan		
Subscriber Only	\$32.38	\$39.05
Subscriber & Spouse	\$64.76	\$78.10
Subscriber & Child(ren)	\$64.76	\$78.10
Full Family	\$97.14	\$117.15

Medicare and PEBB

The new Medicare Part D prescription drug benefit in will also have an impact on retiree medical expenses. In 2004, those who are eligible will receive a 10-25% discount on prescription drug costs. In addition, low income enrollees

(\$12,569 annual income for an individual and \$16,862 for a married couple) may receive a \$600 per year credit to pay for their prescription drugs. In 2005, Medicare will provide physical exams within 6 months of enrollment in Part B, blood tests for early detection of heart diseases, and diabetes screening. In 2006, all people with Medicare will be able to enroll in plans that cover prescription drugs. Plans will have a \$35 monthly premium and a \$250 deductible. Thereafter Medicare will cover 75% of all costs up to \$2,250 and 95% of all costs above \$3,600. Individuals will be responsible for all prescription drug costs between \$2,250 and \$3,600.

Because of the variety of plans available to retirees enrolled through the PEBB, the Health Care Authority is still analyzing the impact of the Medicare changes in relation to each of those plans. *(See HCA summary of Medicare Prescription Drug, Improvement and Modernization Act of 2003 in Appendix A)*

Policy Analysis

No Pre-funded Medical Coverage

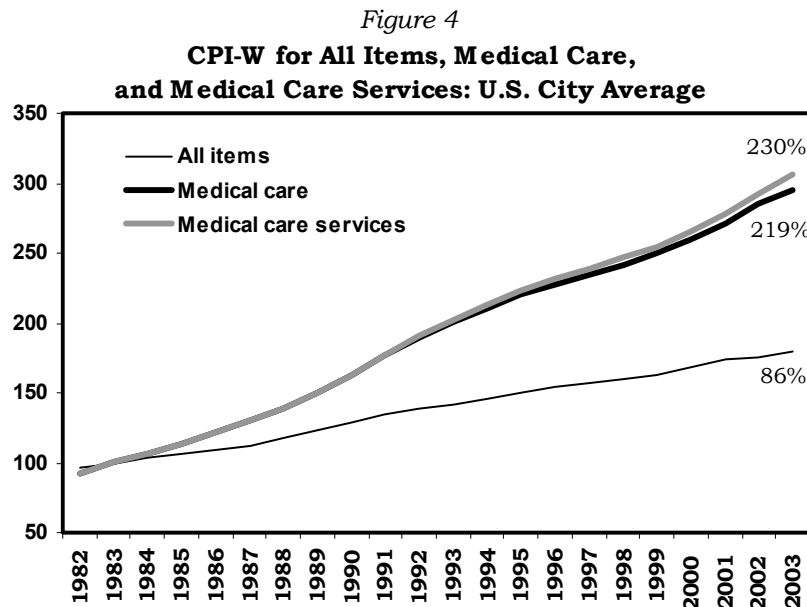
No retirement System/Plan administered by Washington State collects contributions to pre-fund retiree medical benefits. Currently, state, K-12, and higher-ed members who retire before age 65 are allowed to participate in their former employer's risk pool and purchase health insurance at subsidized rates. Even in LEOFF 1, member, employer, and state contributions do not pay for the medical benefits members receive upon retirement. While employers are obligated to provide LEOFF 1 retirees with medical coverage, that coverage is typically provided on a pay-as-you-go basis rather than being pre-funded (there is limited opportunity to pre-fund health insurance liability in a tax qualified trust).

Rising Health Care Expenditures

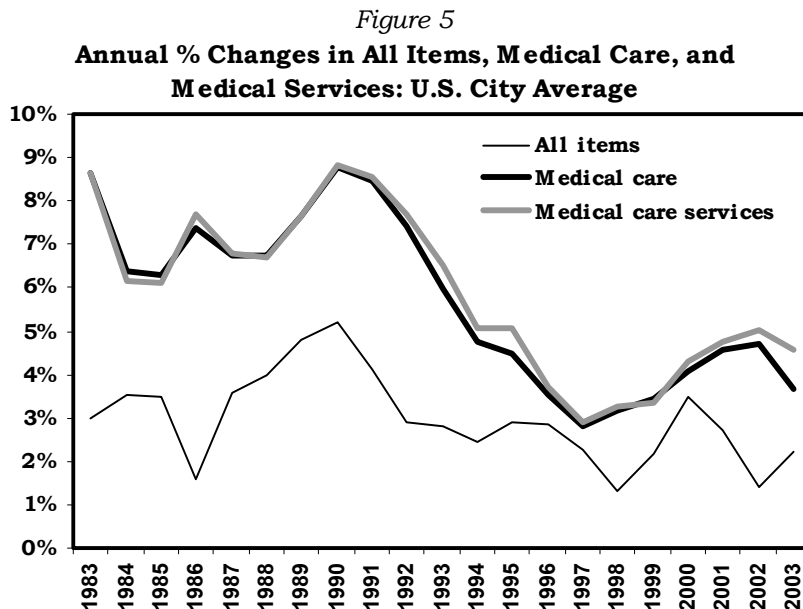
A significant risk facing retirees today is the rising cost of health care. As health care costs rise beyond the average of all other goods and services, they command a greater share of retirees income, forcing them to scale back on other living expenses and thus diminish the overall adequacy of their retirement benefit.

National Trends

As mentioned above, changes in health care costs have out-paced the change in price of other goods and services. In the period from 1982 to 2003, the overall change in consumer prices nationwide was 86%, or about 3% per year (see Figure 4). In comparison the cost of health care and health care services rose 219% and 230 % respectively, or about 6% per year.



While the cost of medical care may have moderated somewhat during this period, there was no year in which medical costs did not out pace the “all item” average (see Figure 5).



For much of the 1990's, health care costs in this country were held in check. In spite of the tight labor market and strong economy, competitive pressures from domestic as well as international sources, and stringent monetary policies were able to keep annual changes in wages and consumer prices at modest levels. Because of this environment, health care benefits were economically feasible for employers to offer.

Recently this trend began to reverse. In 2001, employers experienced an average health care premium increase of 13%.¹ The National Conference of State Legislatures, citing Deloitte & Touche's September 2003 Employer Survey, reports that the costs of employer-sponsored health care plans rose 14.9% in 2003, from an annual \$5,239 per employee in 2002 to \$6,020 per employee. Survey respondents predicted that their 2004 plan costs would rise again an average of 14.3% to \$6,880 per employee.

Nationally, health care spending in 2004 is projected to be \$1.7936 trillion, or 15.5% of the total gross domestic product. This will be \$6,167 per capita. However, during the next ten years health spending is expected to outpace economic growth. As a result, the health share of gross domestic product is projected to increase to 18.4% in 2013 according to the Office of the Actuary at the Centers for Medicare and Medicaid Services.

States Health Costs

As of January 1, 2004, 14 states reported a total employer/employee premium for family coverage of more than \$900 per month according to the 2004 State Employee Benefits Survey by Workplace Economics Inc., a Washington, DC consulting firm. Fifteen states still pay the full cost of health care coverage for individual employees prior to Medicare eligibility, while just five of those states pay the full premium for family coverage. In most states, the amount paid by the employee and the state depends on the health plan and level of coverage selected by the employee. In four states - Illinois, Kansas, New Mexico, and West Virginia - the portion of the premium paid by the employee varies by salary. Forty-three states now offer pre-tax flexible spending accounts to assist employees with medical, dental, vision, life insurance, and other expenses not covered by health plans.

Washington Public Employee Benefit Costs

In the State of Washington, the price tag to provide health care coverage to state employees increased about 20% in 2003, with both state employees and state government paying more. The Acting Administrator of the Health Care Authority attributed this increase to a variety of factors, including the runaway increases in prescription drug costs, the aging workforce, and demands from doctors and other providers for higher reimbursements, and new technologies.²

According to Melissa Ahem, a health care economist and associate professor of health policy and administration at WSU Spokane, some of the driving forces behind rising health care costs are: consumers who want it all, from free choice of physician and loaded benefit packages to unlimited services; increasing numbers of uninsured, with associated costs for care delivered in hospital emergency rooms; increased direct-to-consumer marketing of pharmaceuticals; lack of personal responsibility for health, with more obesity, diabetes, heart disease, etc.; and the huge number of baby boomers moving rapidly toward being Medicare recipients.

Individual Health Expenditures Increase with Age

Individual health care expenses are impossible to predict, but even for healthy retirees, health care can be expensive. The average consumer age 65 and older pays not only a larger share of their income for health care, they also pay a greater absolute amount than someone in their peak earnings years (see Figure 6). According to the Bureau of Labor Statistics, Consumer Expenditure Survey, the average household whose head was age 45 to 54 paid \$2,550 in health care expenditures in 2002, or 5.2% of their total household expenses. In comparison, the average household whose head was age 65 or older paid \$3,586 in health care expenditures in 2002, or 12.8% of their total household expenses.

Figure 6

Average Consumer Expenditures by Age
Source: BLS, Consumer Expenditure Survey, 2002

	45 - 54		65 and Over	
	Dollars	Percent	Dollars	Percent
Total Expenditures	\$48,748	100.0%	\$28,105	100.0%
Food & Drink	\$6,693	13.7%	\$4,147	14.8%
Housing	\$15,476	31.7%	\$9,176	32.6%
Apparel	\$2,029	4.2%	\$972	3.5%
Transportation	\$9,173	18.8%	\$4,481	15.9%
Health Care	\$2,550	5.2%	\$3,586	12.8%
Entertainment	\$2,565	5.3%	\$1,139	4.1%
Miscellaneous	\$3,367	6.9%	\$1,638	5.8%
Cash Contributions	\$1,571	3.2%	\$1,679	6.0%
Insurance & Pensions	\$5,323	10.9%	\$1,286	4.6%

Moreover, paying for long-term care can wreak havoc on retirement savings. According to the American Health Care Association, the average American man can now expect to spend \$56,895 on long-term care while the average American woman will spend close to double that, at \$124,370. The price of long-term care is increasing around 7 percent a year. Medicare covers only about 50% of seniors' regular health expenses, excluding nursing home care. The American Association of Retired Persons/People estimates that the national average for the cost of one month in a nursing home is \$4,654, or \$55,848 annually (costs vary widely depending on geographic location).

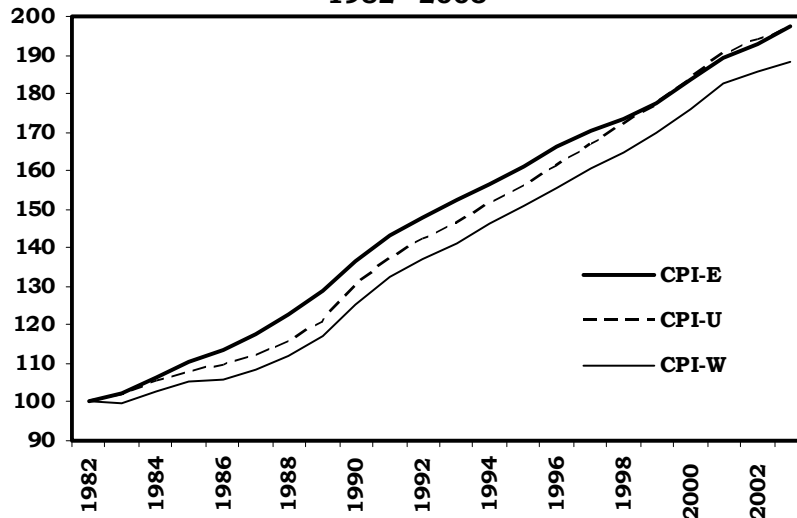
Inflation and Retirement

What is apparent from this analysis is that the Age 65 and Over population has distinctly different spending patterns than younger consumers. As a result, the Consumer Price Index for urban wage earners and clerical workers (CPI-W), which measures price changes in the market basket of a younger working population, would not necessarily be representative of the price changes experienced among older consumers. The CPI-W for the Seattle-Tacoma-Bremerton region is used to adjust the monthly allowances of retired members of the plan 2s.

The disparity in consumption patterns of retirees and workers was the concern driving the establishment of an experimental CPI by the U.S. Department of Labor, Bureau of Labor Statistics. Called the CPI-E, this index measures the changes in consumer prices experienced by the population age 62 and older – age 62 being the youngest at which a retiree may receive Social Security.

Comparing the changes in consumer prices as measured by the CPI-U (all urban consumers) and the CPI-W (wage earners and clerical workers) for the Seattle-Tacoma-Bremerton region, with the experimental CPI-E for the nation produces an interesting result. In the mid-to-late 1980s, the CPI-E rose more quickly than either of the two indices for the Seattle region (see Figure 7). By the mid-to-late 1990s, however, the Seattle CPI-U began to converge with the CPI-E and track in unison. As a result, the CPI-U for the Seattle region closely reflected the changes in consumer prices experienced by the Age 62 and Older population nationwide. What is unknown are the consumer price changes experienced by the local Age 62 and older population compared to the populations represented by the local CPIs.

Figure 7
Comparison of Consumer Price Indecies
1982 - 2003



Retiree Health Benefits Comparisons with Other States

Allowing retirees to pay subsidized premiums to continue their health coverage is a common benefit strategy employed by other states as illustrated in Figure 8. Of the systems examined, CalPERS, CalSTRS, Colorado, and Ohio provided for retiree health insurance through the retirement plans. Other comparable states' retirement systems may or may not administer the retiree health insurance, but it's the retirees who pay the bulk of the premiums.

Figure 8
Retiree Health Care Provisions by Select Retirement Plan

System	Pre-Medicare Eligible	Medicare Eligible
Cal PERS	Recent members need 20 yrs. service to receive 100% of state retiree medical contribution.	Member are eligible for supplemental benefits.
Cal STRS	Depends on bargaining agreement -- may be as much as full medical coverage depending on School District.	Members receive regular Medicare coverage
Colorado PERA	Members and dependents are eligible for PERA Care: subsidized medical, dental, and vision plans.	Members enrolled in Medicare part B are also eligible for PERA Care.
Florida (FRS)	Members may continue in employer provided group insurance plan and receive a subsidy of \$5 per year of service to a maximum of \$150.	Members continue to receive the \$5 per year of service subsidy to a maximum of \$150 per month
Idaho (PERSI)	Members are allowed to continue coverage in the group medical plan.	Members may purchase supplemental depending on employer.
Iowa (IPERS)	Members are allowed to continue with insurance group.	Members need to have both Parts A and B of Medicare and state becomes secondary payer.
Minnesota (MSRS)	Members are allowed to continue with insurance group (may pay into Health Care Savings Plan when employed.)	Members are eligible for a Medigap policy
Missouri (MOSERS)	Members and family are eligible to participate in any employer provided group insurance plans	Members and family are eligible to participate in any employer provided group insurance plans
Ohio (OPERS)	Majority of health premiums paid by OPERS. Remaining premiums deducted from the recipient's monthly benefit check.	Medicare part B reimbursed. Ohio plans become secondary payers.
Oregon PERS	Members may purchase group health and dental insurance.	Retiree may purchase Medicare companion insurance, state provides \$60/month subsidy
Seattle (SCERS)	Members may continue coverage at group rates	Medicare supplemental insurance available

All 50 states make health insurance available to retirees up to the age of 65 and 48 states provide coverage under the state plan for retirees age 65 or older. In 11 states, the state pays the full cost of individual coverage for retirees under age 65, who are not yet eligible for Medicare. Seventeen states pay the full premium for Medicare-eligible retirees over the age of 65. Several states reported that the retiree's share of health care premiums depends upon the date hired, date of retirement or years of service at retirement.³

Other Washington Systems/Plans

All retired state, K-12, and Higher-education members of the systems/plans administered by Washington State are eligible to continue their health coverage if they pay the premiums formerly paid by their employer. The only system/plan that offers comprehensive medical coverage for retirees at no cost to the retiree is LEOFF 1, though retirees are still obligated to pay for coverage of their spouse and dependants. Contributions to LEOFF 1 plan, when necessary, required 6% of salary from both the employer and employee with any additional contributions provided by the State – historically double or triple the employer and employee rate. But even at this high level of funding, those contributions did not pay for retiree medical care; that is solely an obligation of the employer, and provided on a pay-as-you-go basis.

Benefits, Compensation and Retirement

Employment benefits have become an increasingly large part of the public employee's compensation package. These benefits include not just retirement plans, but also holiday, vacation, personal, funeral, jury duty, military, family, and sick leave; short-term disability, long-term disability, and life insurance; medical, dental, and vision care; and legally required benefits – unemployment insurance and worker's compensation. As these benefits command a higher share of the compensation package, particularly the "in lieu of wages" benefits like health care insurance, the difference between what is provided during employment and what is provided during retirement grows. As a result, the real replacement value of retirement benefits are lessened.

According to the PEBB rate tables an active PERS member with a spouse and child will receive, in 2004, a tax-free health care benefit from their employer worth upwards of \$900 per month -- over \$10,000 per year. As a result, the compensation of such a PERS employee could be over \$55,000 per year

because of the benefits that supplement that average \$45,000 salary. For a 30-year employee, the current benefit structure replaces about 60% of salary, but less than 50% of compensation (see Figure 9). Because of the fixed nature of these benefits, lower wage members' retirement benefits replace less of their compensation, while the replacement rate is more for higher wage members.

Figure 9

Benefit Analysis: Salary and Health Insurance		
	Salary for Retirement	Salary + Pre-retirement Health Insurance
Benefit Base	\$45,000	\$55,000
Retirement Benefit	\$27,000	\$27,000
Replacement Rate	60%	49%

Retirement benefits relative to total compensation is an issue because of the growing cost of health care and the differing definitions of compensation in Washington State. The statutory language in the PERS, SERS, and TRS retirement chapters limits compensation to essentially wages and salaries. The statutory language governing workers compensation benefits, which includes disability retirement, uses a definition of compensation that includes, "...wages, medical, dental, and vision benefits; room and board, housing, fuel, bonuses, and tips."

Note: Statutory language in the PERS and TRS plans includes the term "average final compensation" but define compensation so as to exclude all other components of the compensation package save wages and salaries. The LEOFF and State Patrol plans use the statutory term "average final salary."

Report Highlights

- State, K-12, and Higher-education retirees are allowed to purchase health insurance through the Public Employee's Benefits Board administered by the Health Care Authority.
- Current premiums range from a low of \$125 per month for a single member enrolled in Medicare Parts A and B, to over \$1,000 per month for a member with a spouse and child and not yet Medicare eligible.

- The 2004 weighted average premium for retirees not yet Medicare eligible was \$469.20
- The 2004 weighted average premium for Medicare-eligible retirees was \$333.14, of which \$102.35 was subsidized.
- Total health care costs for State, K-12, and Higher Education retirees was an estimated \$223 million in the latest biennium.
- Current retirement policies do not provide for pre-funded medical insurance.
- LEOFF 1 retirees receive full medical coverage on a pay-as-you-go basis.
- Consumer prices have risen 86% since 1982 while medical costs have risen upwards of 230%.
- Costs are up because of prescription drugs, aging workforce, higher reimbursements, new technologies, emergency room care for the uninsured, increased obesity, diabetes, and heart disease.
- Those 65 and older spent 12.8% of their annual household expenditures on health care.
- The Seattle CPI-U is more representative of consumer price changes experienced by retirees than the CPI-W.
- A few states pay for retiree medical through their retirement plans, but most subsidize retiree insurance premiums by allowing retirees to join an active member risk pool.
- The definition of “compensation” to calculate allowances in the retirement plans excludes employment benefits while the definition of “compensation” to calculate a disability retirement in the Workers Compensation system does include some employment benefits.

Endnotes

1. *Health Affairs, 2/11/04.*
2. *For a comparison of 2002 vs. 2003 employee contributions for health care costs, see the Health Care Authority's Press Release "State employees will pay more for health insurance," August 6, 2002 at www.hca.wa.gov.*
3. *2004 State Employee Benefits Survey, Workplace Economics.*

Appendix A

Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA): Summary

This document provides summary information on two provisions of the MMA that may be of interest to the Select Committee on Pension Policy.

Part D and the Employer Subsidy

The MMA's highest profile provision was the creation of a drug benefit in Medicare. Currently there is no drug benefit in Medicare Parts A (facility), B (physician), or C (A & B risk/ Medicare Advantage). MMA creates Part D of Medicare, an optional drug benefit that becomes available effective January 1, 2006. Part D will be available through private risk bearing entities: Prescription Drug Plans (PDPs), and Medicare Advantage-Prescription Drug Plans (MA-PD).

Employers that offer retiree health coverage that includes a prescription drug benefit have several options in response to the creation of the Part D benefit:

1. Employers can collect an employer subsidy payment from Medicare for a portion of the drug costs of retirees and their Medicare dependants who do not sign up for Part D. To be eligible for the employer subsidy, the pharmacy benefit provided by the employer must be actuarially equivalent to the Part D benefit. It is not clear whether PEBB retiree coverage will meet that test based on the current retiree subsidy amount paid by the State for retirees.
2. Employers can wrap around the Part D benefit and coordinate with Medicare. The design of the Part D benefit includes a "True Out of Pocket Cost" requirement that makes coordination of benefits less attractive to employers. Amounts paid by employer based insurance do not count toward the beneficiary's True Out of Pocket Cost requirement, so the point at which the Part D catastrophic coverage kicks in is significantly delayed.
3. Employers can sponsor a PDP for their Medicare retirees.

Regulations governing Part D are not final, so analysis of these options is not complete.

Medicare Supplemental- Medigap

Effective 1/1/06, the MMA prohibits the selling, issuance, or renewal of existing Medigap policies with prescription drug coverage to Medicare Part D enrollees. Medigap policy holders may keep their policy with drug coverage and choose to NOT enroll in Part D, but could face a premium penalty should they choose to enroll in Part D at a later date. Also, MMA requests that the National Association of Insurance Commissioners (NAIC) review and revise standards for Medigap policies. The revision is to make the standard policies compliant with MMA and to include two new benefit packages.

NAIC has not formally adopted a new Medigap regulation, but has distributed a draft that is unlikely to see major revisions between now and when it is formally adopted. The draft regulation adds 2 new standard plans, K & L, to the existing plans A through J. In the draft the pharmacy benefit is removed from plans H, I, and J. And, in the draft, plans F and J have a high deductible option. PEBB currently offers plans E & J to its members.

MMA Summary Prepared by HCA
8/18/04

Select Committee on Pension Policy

Military Service Credit

(August 31, 2004)

Issue The issue before the Executive Committee is whether to recommend changes to existing plan provisions governing military service credit.

Staff Laura Harper, Senior Research Analyst/Legal
360-586-7616

Members Impacted All members of Washington's retirement systems may avail themselves of some form of military service credit. "Interruptive" military service credit is available to those who interrupt public employment to serve in the uniformed military branches of the United States. This type of service is governed by the federal Uniformed Services Employment and Re-employment Rights Act (USERRA)¹. The act is described in more detail under the heading "Current Situation."

In addition, two of Washington's closed plans, PERS 1 and WSP 1, allow members with 25 years of service credit to receive up to five service credit years for "prior" military service (military service which took place prior to retirement system membership). This service credit is available at no additional cost to members. Prior military service credit is not available to members of LEOFF 1 or TRS 1, nor is it available to any members of the Plans 2 or 3.

Incidence of Prior Military Service			
	Percent with Military Service	Average Military Service Months	Overall Average Additional Service Years
PERS 1*			
Males	48%	37	1.48
Females	1%	35	0.03
WSP**	43%	32	1.15

Members with 25 years of service may receive up to 5 years of military service credit

*Members of PERS Plan 1 may use certain prior military service as well as interruptive military service

** Members of WSP Plan 1 may use all prior military service as well as interruptive military service

Members of WSP Plan 2 (those commissioned on or after January 1, 2003) may use only interruptive military service

The above table summarizes the incidence of prior military service in PERS 1 and in the WSP Plans. The table below compares the percentages of male and female members in PERS 1 and the WSP.

Plan Membership by Gender*					
	Total	Male		Female	
PERS 1	21,737	9,586	(44%)	12,151	(56%)
WSP	1,035	959	(93%)	76	(7%)

*At September 30, 2002

Current Situation

Interruptive Military Service: Interruptive military service is governed by federal law. At a minimum, public employers must provide the protections specified in the Uniformed Services Employment and Re-employment Rights Act (USERRA). USERRA was signed into law in 1994, with amendments made in 1996, 1998 and 2000. This law provides for the re-employment of individuals who leave employment to serve in the uniformed military branches. Included in USERRA's re-employment rights is the right to restoration of retirement plan benefits.

For employers, the fundamental requirement of USERRA as it relates to retirement plan benefits is to fund the benefits that a re-employed participant did not receive due to qualifying military service. The employee must be treated for vesting and benefit accrual purposes as if he or she had remained continuously employed. Employers do not have to begin making up pension contributions until after the veteran returns to civilian employment with the same employer. Employers may fund makeup contributions over a period of three times the military service period, not to exceed five years. A rehired veteran is not entitled to missed allocations for any lost earnings on makeup contributions.

Generally, under USERRA, rehired veterans have up to three times the period of service - not to exceed five years - to make up missed employee contributions. The amount of makeup contributions is subject to the limits that would have applied during the military service period. No interest is charged on the contributions, because rehired veterans can only be charged the amount they would have been permitted or required to contribute had they remained continuously employed throughout the period of military service. The Washington State Retirement Systems allow a five-year payback period for employee contributions, regardless of the period of military service. An exception to the USERRA payback requirements exists for members of PERS 1 who apply for reinstatement of employment, are refused for reasons beyond their control, and who resume public service within ten years. Such members shall have the military service credited to them at no cost upon resumption of public service as provided in RCW 41.40.170.

Prior Military Service: As stated above, there is an inconsistency with respect to retirement plan members' ability to receive service credit for prior military service. This benefit is only available to members of WSP 1 and PERS 1. All other plan members are only allowed service credit for interruptive military service.

Members of PERS 1 and WSP 1 must have 25 service credit years to be eligible to receive credit for military service prior to retirement plan membership. Total interruptive and prior military service credit cannot exceed five years, and in both plans the members must restore all withdrawn accumulated contributions in order to receive credit for the prior service. No member payments are required for prior military service credit.

History

Military service credit was reviewed by the Joint Committee on Pension Policy (JCPP) in 1988 and by the Executive Committee of the JCPP in 1997. In 1988 military service credit was evaluated as part of a comprehensive analysis of the provisions for granting service credit. Upon completion of its study, the JCPP concluded that the state's policy was not to grant additional service credit for prior military service. In 1997, the JCPP Executive Committee heard an update on military service credit but the issue was not heard by the full committee.

Since 1996, two JCPP bills on military service credit passed in the legislature, and both were to conform Washington law to federal law (USERRA). At least twenty more bills were filed to expand opportunities to acquire military service credit, but none passed.

Due to the war in Iraq there has been a renewed interest in the effects of military service on employee benefits. During the 2004 legislative session, the OSA tracked five non-SCPP bills concerning military service, none of which passed. Two of these bills, HB 2415 and SSB 6071 would have expanded the definition of "veteran" for various purposes. HB 2415 would have expanded the definition of veteran to include a U.S. documented merchant mariner with service aboard an oceangoing vessel operated by the Department of Defense or its agents during the Korean and Vietnam wars. SSB 6071 would have exempted veterans of the Afghanistan conflict and Persian Gulf War II from certain increases in tuition and fees for higher education. Another bill, 2SSB 6578, would have provided up to two years of military leave during which employees of the state would receive one-half of the difference between their normal pay and their combined military pay and allowances.

The remaining two bills, SB 6743 and SB 6492, would have allowed members of TRS 1 with 25 service credit years to receive up to five years of service credit for prior military service. The two bills differed in the amount of contributions members would be required to pay to receive the service credit: SB 6492 required a contribution "as determined by the Director of the Retirement Systems;" and SB 6743 required "six percent of the average earnable compensation for the two highest compensated consecutive years of service for each year of prior military service credited." Currently, no payments are required from members of PERS 1 and WSP 1 who receive credit for prior military service.

Examples

- A. **Prior Military Service:** The following example illustrates how the ability to receive up to five years of prior military service credit can enhance the retirement benefit of a PERS 1 member. A PERS 1 member retiring with 25 years of service credit and an average final compensation (AFC) of \$45,000/year would receive a monthly retirement allowance of \$1,875 (before reductions for optional forms of payment).

$$\frac{2\% \times 25 \text{ years} \times \$45,000}{12 \text{ months}} = \$1,875$$

If that same member also had five years of military service before becoming a state employee, his or her monthly retirement allowance would increase to \$2,250 based on 30 years of service credit instead of 25.

$$\frac{2\% \times 30 \text{ years} \times \$45,000}{12 \text{ months}} = \$2,250$$

- B. **Interruptive Military Service:** The following hypothetical example illustrates how a member who is called into active duty may obtain service credit for interruptive military service. Consider a member of the Washington State Patrol Retirement System (WSPRS) who was hired July 1, 1999 and was called into active service from July 1, 2003 through June 30, 2004 after completing four years of service with WSPRS. This member's salary was \$40,000 when he left employment and he was required to make an employee contribution of 2% of salary during the period of active service. There was no required employer contribution. Assuming that the member is re-employed upon his return from active duty (according to the terms and conditions set forth in USERRA), the member has five years (more generous than USERRA's three years) to pay back the contributions he would have paid had he remained continuously employed. Therefore his total payment obligation is:

$$2\% \times \$40,000 \times 1 \text{ year} = \$800$$

Assuming repayment, the member is treated as if he had been continuously employed and his service credit had continued to accrue while away on active duty. The member's vesting date (based on a five-year vesting period for this plan) will be July 1, 2004. *Note:* the member's payback will vary from plan to plan, as member contribution

rates differ throughout the Washington State Retirement Systems. See the 2004 SCPP Orientation Manual for more information on contribution rates.

Policy Analysis

Prior Service: As noted above, the JCPP concluded in 1988, upon completion of its study of service credit, that the state's policy was not to grant additional (prior) service credit for military service.

Policies that *support* granting prior military service credit in other Washington plans include the following:

- Recognition of Service: Granting military service credit that is either partially or wholly funded by the state would recognize the service rendered by individuals to our country.
- Service in the military might have delayed the beginning of a member's career with the state and deprived the member of the opportunity to earn a better retirement benefit.
- Parity: Prior military service is provided only to the PERS and WSP Plans 1. There has been pressure from members of other systems for similar benefits. RCW 41.50.005(1) sets forth as retirement policy that the retirement systems of the state shall provide similar benefits whenever possible.

The following policies would *oppose* granting prior military service credit in the other plans:

- Cost: Granting additional military service credit to plan members without requiring payment of the full actuarial cost results in additional liabilities. For plans like TRS 1 that are not fully funded, this means additional unfunded liability and a lower funding ratio.
- Granting additional military service credit at little or no cost would provide a benefit for periods when no service was rendered within the plan.

- The last military draft ended in 1973. Since military service is now voluntary, the interruption of a public employee's career to enter the uniformed services prior to entering public employment is voluntary, which can be seen as reducing the need for taxpayers to pay for retirement benefits during such periods.

While a future change in federal policy is always a possibility, there are no official plans in Washington for reinstating the military draft at this time. Congress would have to authorize it, and has shown no interest in taking such a step. Defense Secretary Donald Rumsfeld indicated in March, 2004 that he would not ask Congress to authorize a draft. However, the Selective Service System, the independent federal agency that would organize any conscription, has a special system to register and draft health care personnel ages 20 to 44 if necessary in a crisis. The agency is planning to expand this system to be able to rapidly register and draft computer specialists and linguists, should the need ever arise. Seattle Post-Intelligencer, "Agency Initiates Steps for Selective Draft," March 13, 2004.²

Interruptive Service: With respect to interruptive service, state retirement policy is constrained by the requirements of USERRA. All public employers must meet the minimum requirements of this federal law. However, states have the discretion to go beyond USERRA and grant benefits for the period of interruptive service that are more generous than those available under the act. The goal of USERRA is to treat employees who are called to active duty as if they had been continuously employed. Employers who choose to go beyond USERRA may reward active duty by paying all or part of the contributions that the member would have paid during the period of active duty. They may also provide all or part of the member's salary during the period of active service.

Comparison with other Retirement Systems: The following is a comparison of military service credit provisions in Washington's comparative retirement systems:

Retirement System	Prior Service	Interruptive Service
1. Washington State ³	Prior with 5-year cap in PERS 1 and WSP 1 only at no cost to member; not available in other plans	Interruptive as provided in USERRA*
2. City of Seattle ⁴	Prior with 5-year cap at actuarial cost	Interruptive as provided in USERRA
3. Oregon (PERS and PSRP) ⁵	None	Interruptive as provided in USERRA
4. Public Employee Retirement System of Idaho (PERSI) ⁶	None	Interruptive as provided in USERRA, but at no cost to member unless employer pays <i>full</i> salary while on active duty
5. CalPERS ⁷	Prior with 4-year cap, or Peace Corps and AmeriCorps VISTA with 3-year cap, at actuarial cost	Interruptive as provided in USERRA, but at no cost to member if re-employed within 6 months of discharge
6. CalSTERS ⁸	None	Interruptive as provided in USERRA
7. Colorado PERA ⁹	None	Interruptive as provided in USERRA, but at no cost to member unless employer pays salary while on active duty
8. Florida Retirement System (FRS) ¹⁰	Depending on hire date, prior with 4-year cap is available at statutory cost (% of salary + interest)	Interruptive as provided in USERRA
9. Iowa (IPERS) ¹¹	Prior at actuarial cost	Interruptive as provided in USERRA
10. Minnesota (SRS and TRA) ¹²	Prior at actuarial cost	Interruptive as provided in USERRA
11. Missouri (MOSERS) ¹³	Prior with 4-year cap at statutory cost (in an amount equal to the state contribution) plus interest	Interruptive as provided in USERRA
12. Ohio (OPERS) ¹⁴	Prior with 5-year cap (+an additional 5 years if a POW) at percentage of salary as set by Board (cost cannot be less than 50% of actuarial cost)	Interruptive as provided in USERRA

*An exception exists for members of PERS 1, who may receive interruptive military service credit at no cost pursuant to RCW 41.40.170.

The provisions for interruptive military service credit are relatively consistent due to the requirements of USERRA. A few states have gone beyond USERRA and provided interruptive service at little or no cost. With respect to prior service, there is a wide range of approaches. Some states do not allow service credit for prior military service. Others allow it, but impose limits on the amount of prior service. The cost to members ranges from \$0 to full actuarial cost.

Some employers in some states may pay all or part of a members salary when the member is called for an extended period of active military service. In Idaho, members who are receiving *full* salary during active service must continue their employee contributions in order to continue to receive service credit. The ability to continue to accrue service credit during the period of interruptive service may increase benefits to a survivor in the event that the member dies while on active duty. It may also increase the benefit of a member who is unable to return to employment due to a service-related disability.

Some Washington public employers are voluntarily providing pay differential to retirement system members on military leave. Currently, such income cannot be reported to the DRS as “earnable compensation.” Thus members on military leave cannot continue to accrue service credit while on active duty. Instead, they must wait until re-employment and pay back the member contributions they would have made had they been continuously employed. The LEOFF 2 Board is currently exploring an option for legislation to make military pay differential reportable as “earnable compensation.”

The U.S. Congress is also currently paying some attention to employee benefits for those who are called into active military service. On April 21, 2004 the House of Representatives passed HR 1779, which would allow penalty-free withdrawals from qualified retirement plans for those called into active duty for at least 179 days (approximately six months). The contributions may be repaid, but there is no requirement that they must be repaid. As of August 25, 2004, this bill was still in the Senate Finance Committee.¹⁵

There are a number of state and federal benefits available to veterans and their survivors. State veteran benefits and programs are summarized on Washington’s Department of Veterans Affairs website, www.dva.wa.gov. This website also provides links to the US Department of Veterans Affairs website, www.va.gov, which summarizes federal benefits. Most of the benefits described on these websites do not address rights and benefits under the Washington State Retirement Systems.

Limitations of USERRA and Possible Remedies

While USERRA provides for the restoration of retirement benefits upon re-employment of a member whose public employment was interrupted by military service, it does not address the retirement benefits that would have accrued to members who die while in active service or those who are unable to be re-employed due to a disability. Thus, for example, if a PERS 2 member would have reached ten years of service during the period of interruptive military service and dies in action, but had only nine years of service credit prior to leaving for active duty, the surviving spouse would be limited to a refund (based on nine years of service credit) and would not be able to receive a survivor benefit in the nature of a pension payment (based on ten years of service credit). This could be remedied by allowing the surviving spouse to pay the contributions that the member would have paid but for the military service, and allowing the service credit to accrue to the date of death.

Similarly, if the same member whose public employment was interrupted by military service becomes totally incapacitated for continued employment, that member's disability allowance would be based upon service credit up to the date he/she left employment for military service instead of to the date of disability. Allowing the disabled member to pay the member contributions and restore service credit up to the date of disability would be consistent with the federal policy of treating the veteran for vesting and benefit accrual purposes as if he/she had been continuously employed.

Both of the above-described "remedies" are being explored by the LEOFF 2 Board as possible legislative options for 2005.

Conclusion

There are two types of military service for which service credit is available: prior and interruptive. With respect to prior service, up to five years of service credit is available to members of two plans only: PERS 1 and WSP 1. Most aspects of interruptive service are handled the same in all Washington retirement plans, as all plans must meet the minimum requirements of USERRA. Members covered by USERRA may have their service credit reinstated for the periods of interruptive service upon re-employment and repayment of their member contributions.

Members who are unable to take advantage of USERRA because they die or become disabled while in service could be given similar treatment to those who are re-employed by allowing such members or their survivors to reinstate service credit to the date of death or disability by paying back the applicable member contributions.

Endnotes

1. For complete information about USERRA, see the USERRA Advisor, <http://www.dol.gov/elaws/userra.htm>.
2. For the complete text of this article, see http://seattlepi.nwsourc.com/national/164693_draft13.html.
3. For more information about military service credit in Washington see <http://www.drs.wa.gov>, the Department of Retirement Systems' website.
4. The provisions of the Seattle Municipal Code that govern the City Employees' Retirement System are found in Chapter 4.36 at <http://clerk.ci.seattle.wa.us>. See Section 4.36.124.
5. See links to these plans and the administrative code that governs them at <http://www.pers.state.or.us>.
6. For more information, see "Military Service and your PERSI Benefits" on the Idaho PERSI website, www.persi.state.id.us.
7. See the CalPERS website, www.calPERS.ca.gov.
8. Sources include the CalSTERS website, www.calSTERS.com and Lexis-Nexis, California Code Sections 22850 et seq.
9. See www.copera.org, "How Military Leave Affects Colorado PERA Members."
10. See Section 121.111 of the Florida statutes, <http://www.flsenate.gov/statutes>.
11. See www.ipers.org, "Buying Service - Veteran's Credit Buy-In."
12. See Sections 352.27, 352.275, 356.55, 354.53 and 354.33, Minnesota Statutes, www.revisor.leg.state.mn.us.
13. See <http://www.moga.state.mo.us/statutes/chapters/chap104.htm> for statutes governing military service credit in the Missouri State Employees'

Retirement System, Chapter 104.

14. See www.opers.org/aboutOPERS/membership/servicecredit.shtml and Sections 145.301 and 145.302, Ohio Revised Code, <http://onlinedocs.andersonpublishing.com>.
15. To track the status of HR 1779, visit <http://thomas.loc.gov>. This Act is cited as the “Guardsmen and Reservists Financial Relief Act of 2004.”